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ABSTRACT

Over the past 2 years, nearly half the states have been debating the fairness and/or constitutionality of their school financing systems. Renewed interest can be traced to changing demographic and economic contexts since the 1970s and a decade of reform calling for qualitative school improvements. Although school revenue more than doubled between 1980 and 1990, the source of that revenue changed; a significant decrease in federal revenue has been offset by increases in state and local revenue. Two major issues are making the tax system more balanced and broadening tax bases. Fiscal distress in the 1990s should inspire state and local governments to pursue finance reform. In reforming local taxes, localities have been interested in reducing reliance on the property tax. Resurgence in school finance activity may also be attributed to recent successful challenges to the constitutionality of school finance statutes in Montana, Kentucky, Texas, and New Jersey. The school finance activity during the last 20 years has failed to improve interdistrict equity; some of the new state educational improvement funds may be disequalizing, and other state aid systems are outdated. Future school finance activity will increase as litigation focuses attention on inequities across school districts in particular states and/or the lack of sufficient funds to provide high-quality education services. Appendices summarize school finance cases, outline state school finance studies, and list 21 references. (MLH)

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Education Finance in the 1990s

November 1990

John Augenblick
Steven D. Gold
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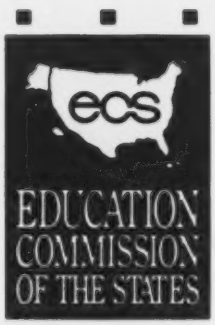

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EXECUTIVE SUMMARY

After nearly two decades in which the funding of schools was not a major policy issue, interest in education finance has increased dramatically. Over the last 24 months, nearly half the states have been engaged in debate about the fairness and/or constitutionality of their school finance systems.

There are at least two reasons for this renewed interest. First, the majority of the basic formulas for distributing aid were designed in the early to mid 1970s, when the economic and demographic contexts within which state finance systems operate were quite different. Second, a decade of reform (prompted by the release of *A Nation at Risk* in 1983) called for qualitative improvements in the schools.

School revenue more than doubled between 1980 and 1990, but the source of that revenue changed, with a significant decrease in reliance on federal revenue offset primarily by increases in state and local revenue. Following a real decrease in the first three years (due primarily to the national recession), revenue grew in real terms in all later years, with particularly large increases in 1984-85 and 1985-86. This change in source has led schools to have a considerable interest in state tax reform.

Two issues of concern are (1) making the tax system more balanced and (2) broadening tax bases. In reforming local taxes, an issue of interest has been reducing the reliance on the property tax or at least making it less objectionable. In discussing property tax, a number of issues arise: how to use it in determining local fiscal capacity, how to reduce the defects of the property tax rather than replacing it, how to mitigate the burden it often places on low- and moderate-income households, and how to initiate truth-in-taxes process to notify taxpayers of proposed budgets and property tax levies.

These issues facing state and local policy makers are diverse and complex. In some ways they are the same issues as in the past two decades, but the fiscal context in which they are being decided will be different in the 1990s. With state and local governments experiencing fiscal stress, it is vitally important for them to reform the ways in which they spend money. Revenue will not be easy to come by in the 1990s, so it needs to be used as wisely and effectively as possible.

Also contributing to the resurgence in school finance activity of the early 1990s is the recent success of challenges to the constitutionality of school finance statutes in such states as Montana (1989), Kentucky (1989), Texas (1989) and New Jersey (1990). But other elements have stimulated the recent tumult in school finance as well. First, there is a sense that the school finance activity of the last 20 years has not accomplished as much as was hoped in terms of improvements in interdistrict fiscal equity. Second, some of the new funds provided by states to improve education may be disequalizing when they do not consider the fiscal capacity of districts. Finally, many state aid systems are getting old, making them less sensitive to the environment within which they operate.

In 1990, school finance activity occurred on multiple fronts: in the courts, in the implementation of new systems and in the studies of existing systems. The court cases in Montana, Kentucky, Texas and New Jersey set the stage for a multitude of new cases that have been filed or are being contemplated. As of November 1990, cases were in progress in Alabama, Alaska, Idaho,

Illinois, Indiana, Kansas, Massachusetts, Michigan, Minnesota, Missouri, North Dakota, Oklahoma, Oregon, Rhode Island and Tennessee, and others were being considered. Many state policy makers are anticipating possible future litigation.

While the decisions in Montana and Texas were fairly traditional, the decision in Kentucky raised the possibility that school finance litigation can lead to restructuring the entire education system. The New Jersey litigation demonstrated that it is possible to focus a case on the way a school finance system affects some, not all, school districts.

In the next few years, school finance activity in the states is likely to grow as litigation focuses attention both on the inequities across school districts in particular states and/or the lack of sufficient funds to provide high-quality education services. The tension between the adequacy, equity and efficiency issues will continue to complicate school finance issues.

This means a number of key points regarding school finance systems will need to be addressed during the 1990s. Among these are the replacement of arbitrary cost indicators; the use of property valuation in determining local fiscal capacity as well as the use of property taxes as the predominant source of local school revenue; alternative ways of identifying resource price differences (e.g., the relationship between cost-of-living and cost-of-education indices); and the use of mandates, classification and allocation of dollars relating to special student categories. Other concerns over school funding systems include: inconsistent programs and strategies (e.g., equalizing expenditures, categorical aid which may ignore equity, the levels and the equalization of local contributions, etc.); what kinds of state aid are equalized and which are not; and the interaction between policy goals related to equity and those related to quality.

As school reform continues, questions about the costs of restructuring schools and the role of the state in stimulating such basic change in the schools will continue to rise.

These questions portend all kinds of issues that range from the nature of the accounting systems used to track and report fiscal information to the role of the school finance system in school-site budgeting. Increasing legislative interest in the use of fiscal incentives also is stimulating questions about the basic structure of school finance systems and the extent to which the state should reimburse districts for their expenditures or should reward them when they meet state goals.

If finance policy is to be a potent force for school reform, finance systems will need to include mechanisms that reach the school site. Direct relationships must be developed between the distribution of state aid and the effectiveness of schools and school districts. How states distribute dollars and how they set the norms and standards for accountability and decision making with respect to these funds cannot remain outside the set of strategies for making schools more productive. State finance systems need to be designed and/or modified in ways that will help focus on the innovation and change efforts currently under way in the schools. This is one of the most important opportunities for policy development in the 1990s.

PREFACE

Two decades have passed since the state role in funding schools became a major education policy issue. During most of the 1980s, there has been relatively little court activity related to school finance. But over the last 24 months, nearly half the states have been engaged in debate about the fairness and/or constitutionality of their school finance systems.

There are a number of explanations for this renewed interest in school finance. First, the majority of the basic formulas for distributing aid were designed in the early to mid 1970s, and much has changed since then. Enrollments, which declined steadily during the middle '70s and early 1980s, are now increasing in some parts of the country. Land values, particularly in agricultural states, are stable to declining, placing upward pressure on local tax rates. And because of new mandates for various special student populations, the program and service requirements of schools have changed. In short, the conditions to which finance systems must be sensitive have changed over the last 20 years.

A decade of reform calling for qualitative improvements in the schools may also explain the new focus on school finance. Efforts to raise graduation requirements, expand student testing and assessment, increase teacher salaries and require new services for students (e.g., early childhood, dropout prevention, employment training, etc.) appear to have amplified concerns about the cost of education and seem to have highlighted existing differences in the resources available to implement these reforms. A 1988 review of state education reform initiatives concluded that the performance of state school finance systems (e.g., providing equal resources) affects local ability to respond to those initiatives.

Whatever the reason, school finance has returned to the center of the policy debate. In the last two years, finance systems in four states have been declared unconstitutional, bringing the number of states where school funding systems have been overturned to seven during the 1980s. A number of states are reviewing their funding formulas. Fifteen more states are in various stages of involvement with the courts.

Overview

This booklet is primarily concerned with developments in school finance during the 1980s and early 1990s. Chapter 1 reviews the economic context in which policy related to schools and school funding has developed. It reviews the fiscal condition of the states, examines trends in revenues and expenditures for schools and discusses prospects for school funding in the 1990s. Chapter 2 addresses the specific reforms in school finance that took place during the 1980s.

But the booklet is also about the relationship between school finance and education reform. Chapter 3 relates emerging education reform issues to school finance and should help to provide a fresh interpretation of the current debate while laying out a school finance reform agenda that is tied to the larger policy debate in education.

As such, this booklet is intended to serve a wide audience of policy makers and their staff, the media and students of education finance and public policy. The last publication of its type, *Education Finance in the States*, was written in 1984.

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State agency personnel who helped with the update of *School Finance at A Glance* have helped in this effort as well. Special thanks to Deborah Verstegen, who orchestrated the collection of these data and updated the earlier version. Mary Fulton was instrumental in collecting and keeping track of all kinds of information, particularly data that related to school finance litigation. Chris Pipho reviewed the entire document for its central purpose and its usefulness to state policy makers.

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CHAPTER 1

THE ECONOMIC CONTEXT FOR SCHOOL FINANCE

Just as an automobile cannot run without gasoline, schools cannot operate without revenue. Schools have substantial revenue, approximately $200 billion in the 1989-90 school year.[1] Schools confront three perennial questions: How much revenue can they obtain? Where will it come from? What difference does it make how it is produced? This paper discusses the answers to these questions, building upon the experience of the 1980s and projecting the likely trends in the 1990s.

School revenue in the 1980s

School revenue increased substantially in the 1980s, more than doubling between 1980 and 1990. The composition of that revenue also changed, with a significant decrease in reliance on federal revenue offset primarily by increases in state and local revenue. An accurate understanding of these past trends is essential for understanding what is likely to occur in the next decade.

Table 1 (page 15) shows the percentage increase in total school revenue from all sources — federal, state, and local — from 1979-80 to 1989-90. The first column, which shows the nominal increase in total revenue, reveals an irregular pattern, with sharp decreases in the growth rate in 1981-82 and 1982-83 as the nation was gripped by a severe recession that sent many states into fiscal crises (and also caused the inflation rate to fall sharply). The increases in 1984-85 and 1985-86 were particularly large, in part because of the efforts to improve schools sparked by publication of *A Nation at Risk* in 1983. The rate of increase in 1984-85 and 1985-86 was, however, not maintained in later years.

The inflation-adjusted revenue increases are shown in the second column of Table 1. Following a real decrease in the first three years of the decade, revenue grew in real terms in all later years, with particularly large increases in 1984-85 and 1985-86.

It is significant that the states with the largest total revenue increases relied on both state and local governments to provide substantial growth of revenue.

The third column of Table 1 goes a step further by showing the increases in inflation-adjusted revenue per student enrolled. Enrollment fell 5.8% between 1979-80 and 1984-85 and then rebounded 2.9% in the next five years. This adjustment tends to raise the percentage increases in the first half of the 1980s and to decrease them in the second half, reducing the amplitude of the fluctuations in growth from year to year. Real per-student revenue grew 2.3% or 2.4% per year in 1986-87, 1987-88 and 1988-89, about half as fast as it had increased in the previous two years.

As Table 2 (page 16) shows, this analysis of changes in total revenue blends together three different revenue streams — federal, state and local. Federal revenue increased 40.7% in the decade, but this represented a 15.6% real decrease. Federal aid fell 9.3% in nominal terms in the 1981-82 school year and increased in nominal dollars in later years, but the increases tended to be less than the increases in state and local revenue.

Between 1979-80 and 1989-90, the increases in state and local revenues were 106.7% and 118.6%, respectively. In certain years, state revenue rose considerably faster than local revenue, particularly 1984-85, 1985-86, 1986-87 and 1988-89, but for the decade as a whole, state revenue increases trailed behind those in local revenue. In the last two years of the decade (1988-89 and 1989-90), the state share of school revenue was 50.0% and 49.4%, respectively, representing a relatively small change from 1979-80, when it was 49.1%. In contrast to this relative constancy, the local share rose from 41.7% in 1979-80 to 43.6% in 1988-89 and 44.3% in 1989-90. Correspondingly, the federal share fell from 9.2% in 1979-80 to 6.4% in 1988-89 and 6.3% in 1989-90. (Because the data for 1989-90 are preliminary and may be substantially revised, this discussion presents information both for it and for the previous year. The figures through 1988-89 are more reliable but less timely.)

The national data obscure important differences in trends among the states. Table 3 (page 17) shows the increases in total, state and local revenue per student in each state between 1982-83 and 1988-89, and Table 4 (page 18) shows changes in the share of state-local revenue provided by the state government. The states with the largest increases in revenue per student were all in New England — Connecticut, Maine, New Hampshire, Rhode Island and Vermont, while the states with the smallest increases were Louisiana, Oklahoma, South Dakota, Utah and Wyoming.

States differed considerably in their relative reliance on state and local governments to provide revenue increases for schools. The five states where *state* revenue increases exceeded local revenue increases by the greatest margin were Wyoming, Connecticut, Rhode Island, Minnesota and Iowa. (Technically, Hawaii is also in this group, but this is misleading because the state is responsible for nearly all school financing.) The five states in the opposite position, with particularly large *local* revenue increases, were South Carolina, Virginia, Nevada, Arizona and Oklahoma.

It is significant that the states with the largest *total* revenue increases relied on both state and local governments to provide substantial growth of revenue. States that relied primarily on either state or local revenue, but not both, were generally not among the leaders in increasing total revenue. Arkansas and Tennessee are examples of states where state sales tax increases were not accompanied by large local

*...state spending for elementary-secondary schools per $100 of personal income fell in the early 1980s. State finances were depressed but then rebounded as the economy improved and publicity from **A Nation at Risk** called attention to the inadequacies of the education system.*

revenue increases, with the result that school revenues did not have a particularly large increase.

Table 4 shows the state share of school revenue (excluding federal aid) in 1982-83 and 1988-89 and the change between those years. In 23 of the 41 states for which data are available in both years, the state share increased.

State spending for schools can be understood better if it is viewed within the context of the total state budget. Table 5 (page 20) traces state spending, excluding expenditures financed by federal aid and user charges. To show how spending grew relative to the economy, it is analyzed in relation to personal income. (Personal income is related to gross national product but is more useful for analyzing state finances because data for it are available for each state.)

As Table 5 shows, state spending for elementary-secondary schools per $100 of personal income fell in the early 1980s. State finances were depressed, but then rebounded as the economy improved and publicity from *A Nation at Risk* called attention to the inadequacies of the education system. As of 1989, however, spending was still lower than it had been in 1980. This record does not suggest a strong national commitment to increase school resources in response to the educational excellence movement.[2]

An important reason why state education spending did not increase more is competition from other state programs, particularly corrections and Medicaid. As Table 5 demonstrates, spending for these two programs has increased much faster than personal income, and they have been capturing a larger proportion of the state budget. In other words, to some extent their higher expenditures have come at the expense of other state programs, including elementary-secondary education. Corrections spending has increased because of the "get-tough-on-criminals" philosophy that swept the nation in the 1980s, with longer sentences resulting in huge increases in prison populations. Medicaid spending has been driven up by inflation in medical costs and by federal mandates to expand coverage.

Another important reason why school revenue did not increase more in the 1980s was the reluctance of states to raise taxes for more school aid. Between 1984 and 1989, only six states increased state taxes explicitly to devote more revenue to schools — Arkansas (1984), Indiana (1987), Kentucky (1986), South Carolina (1984), Tennessee (1984) and Texas (1984). Arkansas, South Carolina and Tennessee each raised the state sales tax rate one cent, Indiana increased its income tax rate, Texas raised the sales tax rate slightly as part of a multifaceted revenue program, and Kentucky enacted a package of proposals that did not raise either the sales or personal income tax rate and turned out to be less productive than believed at the time of passage.

Two related points are relevant here. First, although there were not many large tax increases specifically to increase school spending, neither were such increases common for other specific programs. Those tax increases that did occur were primarily for general budget support (especially because the budget was stressed), rather than for particular programs.

Second, as Table 3 shows, some states were able to increase school revenue considerably despite their refusal to raise state tax rates (because revenue increased substantially due to strong economic growth and/or because other portions of the state budget were squeezed to provide more money for schools). However, the reluctance to increase state taxes certainly inhibited the growth of school budgets.

Twelve states earmark some revenue from state lotteries for elementary-secondary education — California, Florida, Idaho, Illinois, Indiana, Michigan, Montana, New Hampshire, New Jersey, New York, Ohio and West Virginia. Seven of these states initiated their lotteries in the 1980s.

This appears to have changed in 1990. Four states — Kentucky, Nebraska, New Jersey and Oklahoma — raised both sales and income taxes to increase school spending, and two other states — New Mexico and Texas — raised the sales tax rate for that purpose. Each of the increases in the first four states was larger than any of the increases that had occurred since 1984. (That is, they were larger in relation to the size of that state's tax revenue and school spending. Of course, in absolute terms, tax increases tend to be larger in states with bigger populations and economies, so the appropriate way to compare tax changes is in relative terms.)

Composition of state and local tax revenue

When it is said that states provide about half of school revenue, that does not describe from where the revenue actually comes. About 33% of state tax revenue is from the general sales and gross receipts tax, 30% from the personal income tax and 8% from the corporation income tax. The remainder is from excise taxes and business taxes not based on corporate income.

As Table 6 (page 21) shows, the proportion of state tax revenue from the sales and income tax increased considerably in the 1970s and 1980s. The result has been a decrease in reliance on excise taxes.

Although state revenue for schools comes overwhelmingly from taxes, lotteries have also been increasingly tapped. Twelve states earmark some revenue from state lotteries for elementary-secondary education — California, Florida, Idaho, Illinois, Indiana, Michigan, Montana, New Hampshire, New Jersey, New York, Ohio and West Virginia. Seven of these states initiated their lotteries in the 1980s.

Despite the fact that lotteries were the fastest-growing category of state revenue in the 1980s, lotteries play at most a minor role in financing schools. One reason is that lotteries produce relatively little revenue in comparison with the revenue generated by taxes. In the state with the greatest reliance on the lottery, lottery revenue represents no more than 6% of total tax revenue.[3] In addition, earmarking is usually of little practical significance in school finance because of the fungibility of revenue.

Locally raised school revenue is predominantly from the property tax. In 1987-88, 97.4% of school district tax revenue came from the property tax. Approximately 0.8% was from local income taxes, 0.7% from local sales taxes and 1.0% from other taxes.[4] The states where nonproperty tax revenue is particularly important are Louisiana, where local sales taxes are significant, and Kentucky and Pennsylvania, where local payroll taxes are of some importance as revenue sources for schools.

These figures understate the role of local sales and income taxes because they relate only to taxes collected by independent school districts. Where the schools are operated by city or county governments, it is more common for them to obtain revenue from local sales and income taxes. Additionally, this discussion relates only to *locally raised* taxes. In some states, officials have reported on national surveys that income or sales taxes represent a significant proportion of school revenue, but they were referring to *state* taxes passed down to schools through aid programs.

Why changes in revenue composition matter

Changes in the composition of school revenue result from three phenomena — shifts in the relative

A common fallacy is to confuse the role of the property tax in school finance with the issue of how much revenue is collected at the state vs. the local level. It is often argued, for example, that inequalities of educational opportunity exist because the property tax plays such a large role in financing

reliance on state vs. local revenue sources, changes in the composition of state revenue and changes in the composition of local revenue.

The relative reliance on state vs. local revenue sources has an important effect on the ability of the state to reduce fiscal disparities — inequalities in the ability of school districts to finance services. When there is a heavy reliance on local taxes, it is harder to reduce these disparities. Reliance on state taxes makes it possible to equalize resources, but it does not guarantee that this will occur, since that depends on how state aid is distributed.

A change in the composition of state and local revenue is important for at least four reasons:

- It affects the growth rate of revenue because some revenue sources tend to grow more rapidly than others. Economists refer to this as the elasticity of a tax, where elasticity is the percentage increase in revenue resulting from a 1% increase in personal income. In general, the personal income tax has an elasticity above 1, the general sales tax close to 1 and the property tax below 1. Thus, when the income tax is raised to relieve the property tax, the growth rate of revenue tends to increase.
- It affects the progressivity or regressivity of the tax system. The personal income tax is progressive, the sales tax is regressive (with the degree of regressivity depending on which exemptions are provided), and the property tax is usually regressive at low income levels and progressive at high income levels. (The latter varies depending on how the tax is administered, the nature of the property tax base and housing market and tax-relief programs.)
- It affects horizontal equity, which is defined as "equal treatment of equals." Two households that are equally well off should have the same tax burden.
- It affects the stability of the tax system, since the revenue from some taxes is more volatile than others. For example, a sales tax that exempts many so-called "necessities" is relatively unstable. The property tax is considerably more stable than the income or sales tax.

As noted above, there has been a trend at the state level toward increased reliance on income and sales taxes. While this trend has increased the elasticity (responsiveness to economic growth) and progressivity of state tax systems, it has also made them more unstable, since income and sales taxes are relatively sensitive to economic fluctuations.

There has been relatively little change in the composition of locally raised tax revenue, with the property tax still overwhelmingly important. Two states that have increased reliance on local option income taxes to a small extent are Iowa and Ohio. The differences in their approaches are significant.

Iowa's tax is a supplement to the state income tax. Because that tax is progressive, this local tax is also progressive. Ohio's tax is not on all income but only on wages and salaries, so it is regressive (because interest, dividends and capital gains are much more significant income sources at high income levels).

These taxes play a relatively small role in school finance in both states. They are used by 58 of 430 school districts in Iowa, generating only $8.5 million statewide out of total school revenue of $1.5 billion. Fewer than 7% of school districts in

Ohio employ the income tax. In both states, relatively affluent rural districts are the major users. Even school districts where the local income tax is imposed continue to receive the great majority of their local tax revenue from the property tax.

A common fallacy is to confuse the role of the property tax in school finance with the issue of how much revenue is collected at the state vs. the local level. It is often argued, for example, that inequalities of educational opportunity exist because the property tax plays such a large role in financing schools. Often, however, it is reliance on *local* taxes rather than reliance on the *property tax per se* that is responsible for inequalities. Shifting reliance from the property tax to a local income tax, for example, might not reduce inequalities much, if at all. Switching to a state income tax, however, is a different matter, since state financing makes it possible to redistribute resources geographically.

Earmarking

At least 27 states earmark[5] tax revenue to schools — that is, certain revenue streams are dedicated to school aid on a continuing basis. Although this often involves minor taxes like those on tobacco or mineral severance, in at least 11 states a portion of the general sales tax is earmarked, and in four states, part of the personal income tax.[6] As discussed above, 12 states also earmark lottery proceeds for education.

Because revenue is fungible, the conventional kind of earmarking increases education spending by considerably less than the amount of revenue that it earmarked. If schools receive additional money from a new earmarked tax, they are likely to receive a smaller allocation of revenue from general tax sources, thereby reducing or eliminating the benefit they apparently receive from the earmarking provision. Education aid is particularly vulnerable to the fungibility phenomenon because school aid is such a large amount that newly earmarked revenue is invariably considerably less than the total school aid budget.

Here is an example. Suppose that a state spent $2 billion on school aid in year one. Then it raised the sales tax and earmarked the new revenue for school aid, with the new tax yielding $400 million. How much will school aid be in year two?

- The best case would be for total school aid to increase to more than $2.4 billion. This would be the result if all of the earmarked revenue were dedicated to education and nothing were subtracted from what schools would otherwise have received. Without earmarking, school aid would probably have increased to at least $2.1 billion because of inflation, economic growth or enrollment increases. It is unlikely, however, that education aid will increase to more than $2.4 billion, so some of the earmarked revenue will benefit other noneducation programs.
- The worst case would be for school aid to remain unchanged at $2 billion, with the state reducing its appropriation from general funds by $400 million to offset the earmarked revenue. This is unlikely to occur.
- The likely result is that school aid will increase by more than it would have without earmarking but by less than the full amount of the revenue from earmarking.

A very important point is that earmarking sometimes makes it possible to adopt a tax increase or enact a new lottery when that would not otherwise be politically feasible.

The health of state budgets will be affected by at least four major forces — federal policy, the economy, other factors influencing the demand for and costs of services and taxpayer willingness to pay higher taxes.

If so, it increases the total revenue available to state government. Because school aid is such a large part of the budget — approximately 5%, on average — it will inevitably benefit to some extent, even though it will probably not receive all of the increased revenue from earmarking.

A second significant point is that the effect of earmarking is likely to wane over time. When it is first enacted, earmarking will probably add more to school aid than it will after several years in effect. The reason is that school aid would have grown in the absence of earmarking, but no one can tell by how much. Therefore, it is impossible to guarantee that the earmarking provision actually does supplement what would otherwise have been spent for school aid. Recognizing this reality, Arkansas earmarked its 1984 sales tax increase for schools for the first several years after it was enacted but then allowed the formal earmarking provision to lapse.

This discussion relates to the conventional kind of earmarking, where revenue from a specific tax is dedicated to education. Proposition 98, a voter-approved initiative in California, can be viewed as a special case because it provided that a specified percentage of the state budget had to be devoted to education. That type of earmarking is much more difficult to undermine than conventional earmarking and really has resulted in higher education spending.

Revenue issues in the 1990s

School revenue issues in this decade can be divided into two parts: *How much* revenue can schools obtain? *What type of* revenue should schools rely upon? In other words, should the revenue system be reformed?

How much revenue? A discussion of school revenue issues in the 1990s should begin with analysis of the fiscal situation of state governments in general as well as that of local nonschool governments.[7] Aid for elementary and secondary education is such a large share of state general fund budgets that it is inextricably involved with the overall state budget situation. The health of state budgets will be affected by at least four major forces — federal policy, the economy, other factors influencing the demand for and costs of services and taxpayer willingness to pay higher taxes.

States are likely to experience considerable fiscal stress in the 1990s because the forces that exerted upward pressure on their budgets in the 1980s are likely to continue in effect, and some of them will become more severe.

Federal policy. This is a period of "fend-for-yourself federalism."[8] Since the late 1970s, the federal government has been cutting back on its support for domestic services. The impact of those cutbacks on school revenue was shown in the first section of this paper, but it has also had major effects on other kinds of state and local spending. In real dollars, federal grants to state and local governments fell 8% between 1980 and 1989. President Bush's budget proposal for fiscal year 1991 projected a further 14% decrease through 1994.[9]

Another major federal impact on states is through mandates, especially involving Medicaid. Numerous expansions in eligibility and services provided by Medicaid have added several billion dollars per year to state spending, and this trend is likely to continue.

The economy. Economic growth is the most important short-term influence on the health of state finances. When the economy is growing strongly, state revenue is

The picture that emerges from this review of forces affecting state budgets is not a favorable one.

buoyant; when the economy is weak, states tend to have difficulty balancing their budgets. This is well illustrated by the experience of the 1980s. In 1982 and 1983, during the most severe recession since the 1930s, most states had very severe fiscal problems. During the next seven years, as the economy grew uninterruptedly, fiscal difficulties were much less widespread. Regions suffering from localized recessions, such as the energy states in the mid-1980s and the Northeast at the end of the decade, battled to keep their budgets out of the red, but this was not a problem for most states.

The economic environment in the 1990s will probably not be as benign as it has been since 1983. One important reason why such a long period of uninterrupted economic growth occurred is that in 1983 the economy had a large amount of unused capacity. This is no longer true, since the economy is close to full employment.

With relatively full employment of resources, economic growth is constrained by the increase in the productive capacity of the economy, which depends on the growth rate of the labor force and productivity. Most experts expect labor force growth to be low and declining in the 1990s because of demographic trends: new entrants to the labor force are relatively few because in the period following the post-war baby boom (sometimes referred to as the baby bust) there were relatively few births. Thus, unless there is an unexpectedly large increase in immigration that augments the labor force or productivity rises considerably faster than it did since 1973, the economy cannot grow very rapidly. Approximately 2.5% per year may be the best that can be expected.

While no national recessions have occurred in the past seven years, historical precedent suggests that at least two recessions are likely in the 1990s. As noted above, recessions usually cause considerable fiscal difficulty for states because they depress revenue from the income and sales taxes and increase spending for programs such as welfare.

Other influences on service demands and costs. Powerful forces are likely to continue the rapid increases that have been occurring in state spending for Medicaid and corrections. These increases will add to pressure for state tax increases, but they also will come to some extent at the expense of spending for other state programs, including education.

The most important force driving Medicaid spending higher has been inflation in the price of medical services, which has been occurring at twice the general inflation rate. This inflation is likely to continue unabated. Other influences adding to Medicaid costs include the rapid growth in the population over the age of 85, which adds to long-term care needs, and the cost of treatment for AIDS patients, which also will grow rapidly. The National Association of State Budget Officers (NASBO) estimates that state Medicaid spending will increase 17% in fiscal year 1991, the fastest increase in at least a decade, suggesting that Medicaid spending has entered a new rapid growth phase.

Correctional spending will continue to increase rapidly because there is still a large amount of prison overcrowding, and more than three-fourths of the states are under court order or consent decree to improve conditions in prisons. An important element of the so-called "war against drugs" is to send persons convicted of drug offenses to prison. This policy is adding to the pressure for expanding corrections systems. Because the average cost of constructing a cell is $50,000 and the

While some...tax protests may succeed, the record of the 1980s suggests that most will fail—the majority of voters have generally accepted the need for higher taxes when state officials built a strong case for them. If governors and legislators do a poor job of explaining why taxes have to be increased, tax protests will be more successful.

average cost of maintaining a prisoner for a year is $25,000, the "get-tough-on-criminals" philosophy is an expensive one. By the latter half of the 1990s, states could bring corrections costs under control if sentencing and related policies are reformed, but that might not be politically feasible.

The picture that emerges from this review of forces affecting state budgets is not a favorable one. Continued rapid increases in Medicaid and correctional spending, lower levels of federal aid (along with more mandates) and a less favorable economic environment add up to considerable fiscal stress. One way of dealing with this stress is to reform spending and revenue policies to make spending more efficient and revenue more adequate and reliable. Another response is to increase taxes. To what extent will that be feasible?

Taxpayer willingness to pay higher taxes. There is a continuing battle between those wanting higher spending and tax protestors, who want lower taxes. As Table 6 (page 21) shows, state and local taxes have been increasing faster than personal income since 1982, but they still are not as high as they were before the 1978 tax revolt.

The record of the 1980s is mixed. On one hand, every state enacted some tax rate increases in the 1980s, and in most cases at least one substantial increase, especially in the recessionary 1982-83 period. More important, taxes have been growing faster than personal income. On the other hand, the legacy of the tax revolt is not necessarily dead — it may have restrained state tax increases. Three indications of this:

- The state-local sector grew much more slowly in the 1980s than earlier in the post-World War II period.
- Most income tax increases enacted in 1982-83 were partly or completely rolled back once fiscal conditions improved.
- Most states modified their income tax structure in response to the federal tax reform of 1986 so that they did not receive the full "windfall" that would have occurred if they had left their tax rates and exemptions unchanged.

In other words, the tax revolt has had some lasting effects, but it has not by any means prevented all tax increases.

An unusually large number of significant state tax increases occurred in 1990, especially considering that it is an election year in most states. NASBO estimates that total increases exceeded $10 billion, the highest in history (without considering inflation). Nine states enacted increases that raised their total tax revenue by at least 5% (Arizona, Florida, Kentucky, Massachusetts, Nebraska, New Hampshire, New Jersey, Oklahoma and Rhode Island).[10] As noted above, six states increased their personal income, general sales tax or both taxes to boost school spending. So many tax increases for that purpose in a single year is very unusual, in fact, unprecedented since 1971.

The tax increases of 1990 could be a harbinger of an increased willingness to raise taxes in this decade, so tax revenue may grow faster in the 1990s than it did in the 1980s. At a minimum, state and local tax revenue will probably continue to grow somewhat faster than personal income, as it has since 1983. The question is whether it grows much faster or slightly faster.

The tax increases of 1990 and those likely to occur in 1991 will surely lead to a backlash, as tax protestors attempt to defeat officials who supported the tax increases and enact initiatives to roll back the increases. While some of those tax

A balanced tax system relies to a substantial degree on the income, sales and property taxes, as well as minor taxes.

protests may succeed, the record of the 1980s suggests that most will fail — the majority of voters have generally accepted the need for higher taxes when state officials built a strong case for them. If governors and legislators do a poor job of explaining why taxes have to be increased, tax protests will be more successful.

Where should the revenue come from? As discussed above, three questions are involved here: the division of responsibility for raising revenue between the state and local governments, the composition of state revenue and the composition of local revenue. These three questions can be stated as:

- Should state taxes be increased?
- Should state tax revenue be reformed?
- Should local tax revenue be reformed? (A question closely related to the issue of whether the property tax should be replaced by another local tax.)

Raising state taxes. There are three primary reasons for increasing state taxes — to increase school resources, to reduce fiscal disparities and to relieve property taxes.

If the only consideration is increasing school resources, there is no reason why state as opposed to local taxes need to be increased. There are two important implications of relying on the state to increase taxes:

(1) If the state raises the income tax, this is usually considerably more progressive than relying on an increase in the property tax. On the other hand, if the state raises the sales tax, it may or may not be less regressive, but it does have a different incidence than increasing the property tax. Whether the sales or income tax is raised, the impact of the tax on businesses (and owners of farmland) is usually considerably less than it would be if the additional revenue came from the property tax. This implies that the impact of the tax on households is greater.

(2) If local taxes are relied upon to increase school revenue, communities with below-average tax bases will be disadvantaged: they do not have as much ability to generate their own revenue. In other words, relying on the state makes it possible to avoid the fiscal disparities problem.

When state taxes are increased, they may either augment school spending or reduce property taxes. If property tax relief is the goal, the state should combine its increased aid with the imposition of spending limitations. Sometimes property tax relief is the stated goal of increasing aid, but limitations are not imposed; in such cases, a significant portion of the aid may result in higher local spending rather than lower property taxes. Iowa is an example of a state where higher state taxes enacted in 1971 were combined with strict spending limitations, with the result that reliance on property taxes was significantly reduced. Nebraska's 1990 sales and income tax increases were also combined with limitations, so their primary effect will not be to increase school spending but rather to reduce property tax burdens.

Reforming state taxes.[11] Schools have a considerable interest in state tax reform because a reformed tax system will generate stronger, more reliable revenue increases. The reform agenda varies considerably among the states because state tax systems are so different. Two important themes are making the tax

[An]... essential part of good tax policy is to have broad tax bases, that is, tax bases that have relatively few exemptions.

system more balanced and broadening tax bases.

A balanced tax system relies to a substantial degree on the income, sales and property taxes, as well as minor taxes. The most unbalanced tax systems are in the 10 states that do not impose a personal income tax and the five states that do not levy a general sales tax. (Because Alaska and New Hampshire lack both of these taxes, there are 13 states altogether without one or the other or both.) There are also states that impose both a sales and an income tax but have such low rates for one or the other that their revenue system is unbalanced. Until 1990, Nebraska was an example of such a state, with very heavy reliance on the property tax and low reliance on the sales and income taxes.

But in 1990 Nebraska raised both its sales and income taxes while reducing the property tax, thereby making its tax system considerably more balanced. It is good tax policy to have a relatively balanced tax system for several reasons:

- It helps to keep tax rates low (which is desirable, because high tax rates tend to distort location decisions).
- It often will make the tax system more stable, because when it is diversified it is less subject to swings in particular tax bases.
- It often will be fairer and distort resource use less than an unbalanced tax system because it tends to "average out" the defects of each tax. (Every tax has some undesirable features, but if no tax is used excessively, these bad features are not as serious.)

If balance entails increasing reliance on the income tax, it also will increase the elasticity of the tax system.

A second essential part of good tax policy is to have broad tax bases, that is, tax bases that have relatively few exemptions. A broad tax base is desirable for several reasons:

- It helps to keep tax rates low.
- It is fairer because it improves horizontal equity.
- It makes the tax system easier to administer and understand (because artificial distinctions are avoided).
- It may make the tax system more responsive to economic growth (if the exemption eliminated is for something that has a relatively high income elasticity, such as services).
- It may enhance stability (if the exemption eliminated is for something whose use is relatively stable).

Reforming local taxes. Reform of local school taxes means either reducing reliance on the property tax or making it less objectionable.

Reducing reliance on the property tax by instituting a local sales or income tax has a number of significant effects. Evaluating these effects must be done on a state-by-state basis, because their magnitude depends on such factors as the nature of a state's economy, how the property tax is administered and the size of school districts. Six of the major differences among these taxes are:[12]

- *Revenue growth.* Income and sales tax revenue tend to grow more rapidly than property tax revenue.
- *Revenue instability.* Income and sales tax revenue tend to be much less stable and predictable than revenue from the property tax.
- *Regressivity/progressivity.* A broad-based income tax is normally progressive or proportional, while property

and sales taxes are regressive, as is an income tax that is only on wages and salaries.

- *Fiscal disparities.* It is an empirical question whether inequalities among tax bases are greater with a property tax than with a sales or income tax. If school districts are small, the problem of fiscal disparities will tend to be worse because more enclaves will exist. For example, a suburb with a big shopping center and relatively little residential property will benefit greatly from a local sales tax, while a bedroom community with little commercial activity will have a small sales-tax base. Inequalities will exist with a local income tax, but their nature will depend in part on whether tax revenue is based on residence or work place.
- *Exporting of tax burdens.* The extent to which taxes are paid by local residents can be significantly affected by which tax base is used. In Iowa, for example, the local income tax is paid only by residents, in contrast to the property tax, much of which is paid (initially, at least) by nonresident businesses and owners of farmland.
- *Matching benefits and burdens.* Some proponents of the benefit theory of taxation argue that the property tax should not be used to finance schools because the property tax should only finance services that increase property values, such as streets and police and fire protection.

To summarize, shifting from the property tax to a sales or income tax has a major effect on who pays the local tax bill. It also has major effects on the growth and stability of school revenue. If there is increased reliance on local sales or income taxes, the state government should modify its formulas for distributing state aid to schools. In most states, the only measure of local fiscal capacity considered is the property tax base. This is appropriate if the property tax is the only local school tax, but not if sales or income taxes are used locally.[13]

The second aspect of local tax reform involves reducing defects of the property tax rather than replacing it. One such defect is the inaccurate nature of property assessments in many places. This problem can be significantly reduced through reform of the assessment process, involving its professionalization and giving assessors the tools they require to determine assessments accurately. One aspect of assessment reform is relatively frequent reassessments, which not only make assessments more accurate and provide regular increases in school revenue without tax-rate increases but also tend to avoid large sudden changes in assessments which distress taxpayers.[14]

Another problem with the property tax is the heavy burden it often imposes on low- and moderate-income households. This regressivity can be eliminated through state-financed "circuit breakers," which are credits whose value depends on a household's income and the taxes it pays. Because they are targeted, circuit breakers tend to have a relatively low budgetary cost in comparison with types of property tax relief that are not targeted.[15]

A third important reform is the truth-in-taxation process that helps to demystify the property tax. As

The second aspect of local tax reform involves reducing the defects of the property tax rather than replacing it.

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administered in Florida and Utah, the states with the most highly developed and long-established procedures, this process requires notifying taxpayers about proposed budgets and property tax levies, with individualized notices explaining how taxes would be affected by budget proposals and whether tax increases are the result of increased assessments or higher local spending and which local governments are responsible. Although many other states have truth-in-taxation procedures (also known as "full disclosure" in some states), they usually do not require sending individualized notices and hence are much less effective in improving public understanding.[16]

A final issue adds to the complexity of weighing reforms that result in lower property taxes, whether through increased state aid or local revenue diversification. When property taxes are sharply reduced, the value of property tends to increase because the cost of ownership is lower. These windfall capital gains accrue to the present owners of the property, whether they purchased it recently or held it for a long time. Some economists maintain that this phenomenon — referred to as capitalization — complicates the analysis of how fair the property tax is and how much it distorts resource allocation.

Conclusion

The school revenue issues facing state and local policy makers are diverse and complex. In some ways they are the same issues as in the past two decades, but the fiscal context in which they are being decided will be different in the 1990s. Because states are likely to experience more fiscal stress than they have through most of the past two decades, some revenue options rejected in the past may be reconsidered.

Although this chapter has focused on school revenue issues of the 1990s, it should be noted that these issues are inextricably related to the expenditure side of the budget. With state and local governments experiencing fiscal stress, it is vitally important for them to reform the ways in which they spend money to "get a bigger bang for the buck." Restructuring schools is one manifestation of this priority. Revenue will not be easy to come by in the 1990s, so it needs to be used as wisely and effectively as possible.

NOTES

1. National Education Association. *Estimates of School Statistics, 1989-90.*

2. A more upbeat interpretation of this record is provided in Allan Odden, "School Finance Changes in the 1980s," *Education Policy*, vol. 4, no. 1, 1990: pp. 33-47. Odden emphasizes increases in real per-pupil spending rather than the decrease in spending relative to personal income.

3. U.S. Census Bureau. *State Government Finances in 1989;* Steven Gold. "Lotteries: Still Small Change," *State Legislatures*, July 1989: pp. 14-15.

4. U.S. Census Bureau. *Governmental Finances in 1987-88;* U.S. Advisory Commission on Intergovernmental Relations. *Significant Features of Fiscal Federalism, 1990*, vol. 1, pp. 57, 75-76.

5. This discussion relies heavily on Steven Gold, Brenda Erickson and Michelle Kissell. *Earmarking State Taxes.* Denver: National Conference of State Legislatures, 1986. In late 1990 NCSL will publish an update of this study to describe earmarking in fiscal year 1988.

6. Fabricius, Martha A., et al. "Education Earmarking Likely to Continue," *The Fiscal Letter*, July/August 1990, pp. 2-4, 11.

7. Gold, Steven D. *The State Fiscal Agenda for the 1990s.* Denver: National Conference of State Legislatures, 1990, ch. 2.

8. This phrase was coined by John Shannon.

9. Ibid: 4-6. These figures do not include grants for payments to individuals, such as Aid to Families with Dependent Children.

10. Eckl, Corina, Ron Snell and Scott Mackey. *State Budget and Tax Actions in 1990.* Denver: National Conference of State Legislatures, 1990; Marcia Howard. *Fiscal Survey of the States: September 1990.* Washington, D.C.: National Association of State Budget Officers.

11. Gold, *State Fiscal Agenda*, ch. 6.

12. Gold, Steven D. *Reforming State-Local Relations, A Practical Guide.* Denver: National Conference of State Legislatures, 1989, ch. 6.

13. Pogue, Thomas. "School District Fiscal Capacity: Measurement and Equalization," *Proceedings of the Eighty-second Annual Conference: 1989.* Columbus: National Tax Association, 1990.

14. Gold. *Reforming State-Local Relations*, ch. 7.

15. Gold, Steven D. *State Tax Relief for the Poor.* Denver: National Conference of State Legislatures, 1987.

16. Gold. *Reforming State-Local Relations*, ch. 7.

Table 1

Growth of School Revenue, 1979-80 to 1989-90
(percentage change)

Year	Current Dollars	Real Dollars	Real Dollars per Student
1979-80	...	...	...
1980-81	9.1	.2	2.0
1981-82	7.0	-.5	1.7
1982-83	5.7	-.2	0.9
1983-84	7.0	2.1	2.8
1984-85	9.4	4.5	4.6
1985-86	9.1	5.1	4.5
1986-87	6.5	2.8	2.3
1987-88	7.4	3.0	2.3
1988-89	7.8	2.9	2.4
1989-90	5.9	1.5	0.9

Notes:

* 1989-90 data are preliminary.
Revenue includes funds from federal, state, local and other sources.
Inflation is measured by the implicit deflator for state and local government, with calendar years averaged to estimate fiscal years.

Source: National Education Association, *Estimates of School Statistics 1989-90* (Washington, D.C.: NEA, 1990), pp. 11, 21

Table 2

State, Local and Federal Shares of School Revenue,
1979-80 to 1989-90
(Percent of Total)

School Year	State	Local	Federal
1980	49.1	41.7	9.2
1981	48.2	43.1	8.7
1982	47.9	44.7	7.4
1983	47.7	45.1	7.2
1984	47.8	45.2	7.0
1985	49.0	44.2	6.8
1986	49.4	43.9	6.7
1987	49.8	43.8	6.4
1988	49.4	44.2	6.4
1989	50.0	43.6	6.4
1990p.	49.4	44.3	6.3

p. = preliminary data

Source: National Education Association, *Estimates of School Statistics 1989-90*

Table 3

Percentage Increase in School Revenue Per Pupil, Total, State and Local, 1982-83 to 1988-89

State	Total	State	Local
NEW ENGLAND			
Connecticut	94.3%	144.3%	68.3%
Maine	86.8%	97.0%	79.5%
Massachusetts	-	-	-
New Hampshire	76.5%	93.8%	76.9%
Rhode Island	77.8%	117.3%	54.5%
Vermont	88.7%	101.7%	84.2%
MID-ATLANTIC			
Delaware	50.2%	47.8%	64.5%
Maryland	62.3%	57.6%	67.7%
New Jersey	72.7%	92.8%	58.9%
New York	73.7%	85.4%	61.8%
Pennsylvania	60.2%	62.1%	56.3%
GREAT LAKES			
Illinois	41.0%	33.8%	47.7%
Indiana	-	-	-
Michigan	-	-	-
Ohio	42.5%	59.2%	29.5%
Wisconsin	53.8%	58.5%	52.2%
PLAINS			
Iowa	31.5%	61.1%	9.4%
Kansas	35.8%	38.8%	33.3%
Minnesota	43.0%	73.2%	15.8%
Missouri	63.9%	65.9%	67.9%
Nebraska	-	-	-
North Dakota	-	-	-
South Dakota	27.5%	22.3%	28.4%
SOUTHEAST			
Alabama	53.9%	57.3%	43.6%
Arkansas	62.3%	74.2%	54.8%
Florida	64.9%	64.0%	74.2%
Georgia	-	-	-
Kentucky	47.6%	46.0%	66.0%
Louisiana	24.8%	15.7%	32.8%
Mississippi	56.6%	57.3%	76.7%
North Carolina	75.8%	86.9%	74.2%
South Carolina	73.1%	40.5%	152.2%
Tennessee	57.7%	63.0%	57.4%
Virginia	72.2%	41.7%	106.6%
West Virginia	42.0%	42.8%	39.8%
SOUTHWEST			
Arizona	44.6%	27.2%	67.0%
New Mexico	36.6%	37.1%	35.1%
Oklahoma	7.3%	- 4.7%	31.5%
Texas	44.5%	32.3%	55.0%
ROCKY MOUNTAIN			
Colorado			
Idaho	47.3%	46.8%	49.9%
Montana	-	-	-
Utah	17.7%	23.7%	8.8%
Wyoming	14.2%	100.9%	- 28.4%
FAR WEST			
California	70.9%	78.3%	53.8%
Nevada	57.4%	33.4%	84.7%
Oregon	34.6%	21.1%	39.5%
Washington	53.7%	47.9%	74.6%
Alaska	-	-	-
Hawaii	34.9%	36.2%	- 58.9%

Note: States were omitted if they failed to provide data.
Source: National Education Association, *Estimates of School Statistics, 1989-90 and 1982-83*

Table 4

State Share of State-Local School Revenue,
1982-83 and 1988-89,
and Change Between Those Years

State	1988-89	1982-83	Difference
NEW ENGLAND			
Connecticut	46.9%	37.8%	9.1%
Maine	56.2%	53.9%	2.3%
Massachusetts	43.7%	-	-
New Hampshire	7.4%	6.8%	0.6%
Rhode Island	45.8%	37.5%	8.3%
Vermont	39.1%	37.0%	2.1%
MID-ATLANTIC			
Delaware	72.1%	74.2%	- 2.1%
Maryland	41.2%	42.7%	- 1.5%
New Jersey	45.4%	40.7%	4.7%
New York	46.3%	43.0%	3.4%
Pennsylvania	48.4%	47.5%	0.9%
GREAT LAKES			
Illinois	39.2%	41.6%	- 2.4%
Indiana	-	56.8%	-
Michigan	37.7%	-	-
Ohio	50.3%	45.2%	5.1%
Wisconsin	41.4%	40.4%	1.0%
PLAINS			
Iowa	52.9%	43.3%	9.6%
Kansas	45.9%	44.9%	1.0%
Minnesota	57.9%	47.9%	10.0%
Missouri	41.6%	41.9%	- 0.3%
Nebraska	-	30.8%	-
North Dakota	53.4%	-	-
South Dakota	29.2%	30.3%	- 1.0%

Continued on next page

State	1988-89	1982-83	Difference
SOUTHEAST			
Alabama	78.9%	77.3%	1.6%
Arkansas	65.1%	62.3%	2.7%
Florida	57.0%	58.5%	- 1.5%
Georgia	-	62.8%	-
Kentucky	76.7%	78.9%	- 2.2%
Louisiana	61.7%	64.9%	- 3.2%
Mississippi	66.1%	68.7%	- 2.6%
North Carolina	69.7%	68.2%	1.5%
South Carolina	53.6%	67.5%	- 13.9%
Tennessee	53.9%	53.0%	0.9%
Virginia	36.4%	45.5%	- 9.1%
West Virginia	68.4%	68.0%	0.5%
SOUTHWEST			
Arizona	49.0%	55.8%	- 6.8%
New Mexico	85.6%	85.4%	0.2%
Oklahoma	64.4%	71.4%	- 7.0%
Texas	48.0%	52.0%	- 4.0%
ROCKY MOUNTAIN			
Colorado	-	42.6%	-
Idaho	65.2%	65.6%	- 0.5%
Montana	51.2%	-	-
Utah	60.4%	57.3%	3.1%
Wyoming	55.9%	31.1%	24.8%
FAR WEST			
California	74.6%	71.7%	2.9%
Nevada	41.3%	49.3%	- 8.0%
Oregon	28.4%	31.4%	- 3.0%
Washington	76.6%	79.5%	- 2.8%
Alaska	-	83.1%	-
Hawaii	99.9%	99.6%	0.3%

Note: States omitted did not provide data to the National Education Association. The NEA's estimates for three states are not considered reliable.

Source: National Education Association, *Estimates of School Statistics, 1989-90 and 1982-83*

Table 5

State Spending Per $100 of Personal Income,
Excluding Spending Paid for by Federal Aid and User Charges,
1976 to 1989

Year	Total	Higher Education	Elem-Sec Education	Medicaid	Other Welfare	Health & Hospitals	Highways	Corrections	Other
1989	$7.80	$0.91	$2.30	$0.61	$0.40	$0.63	$0.64	$0.37	$1.94
1988	7.91	0.91	2.32	0.60	0.37	0.62	0.66	0.35	2.08
1987	7.86	0.92	2.33	0.56	0.39	0.61	0.66	0.33	2.06
1986	7.67	0.93	2.30	0.55	0.38	0.61	0.63	0.33	1.94
1985	7.55	0.92	2.23	0.55	0.38	0.59	0.60	0.30	1.98
1984	7.37	0.90	2.18	0.56	0.41	0.57	0.59	0.27	1.87
1983	7.27	0.90	2.17	0.56	0.36	0.59	0.60	0.25	1.83
1982	7.28	0.91	2.18	0.51	0.44	0.60	0.61	0.24	1.79
1981	7.43	0.93	2.29	0.49	0.51	0.62	0.65	0.23	1.71
1980	7.41	0.94	2.37	0.45	0.51	0.60	0.74	0.22	1.57
1979	7.28	0.94	2.31	0.41	0.51	0.58	0.72	0.21	1.60
1978	7.27	0.97	2.28	0.38	0.61	0.59	0.70	0.21	1.53
1977	7.49	0.96	2.29	0.38	0.60	0.61	0.69	0.20	1.76
1976	7.68	0.97	2.35	0.33	0.68	0.60	0.83	0.19	1.72

Source: Unless otherwise noted, U.S. Census Bureau, *State Government Finances in (year)*; for higher education, Center for Higher Education, Illinois State University, *Grapevine*; for elementary-secondary education, National Education Association, *Estimates of School Statistics* (annual); for Medicaid, U.S. Health Care Financing Administration

Table 6
State and Local Revenue per $100 of Personal Income, 1970 to 1989

Fiscal Year	Total	Local	State	State				
				General Sales	Personal Income	Corporation Income	Severance	Other
1989	$11.55	$4.55	$7.02	$2.31	$2.20	$0.59	$0.10	$1.83
1988	11.60	4.57	7.05	2.23	2.13	0.58	0.12	1.88
1987	11.48	4.48	7.02	2.26	2.16	0.59	0.12	1.89
1986	11.24	4.37	6.89	2.26	2.04	0.55	0.19	1.85
1985	11.28	4.34	6.97	2.25	2.06	0.57	0.23	1.86
1984	11.30	4.35	6.96	2.21	2.09	0.55	0.26	1.85
1983	10.68	4.25	6.46	2.02	1.88	0.50	0.28	1.78
1982	10.59	4.12	6.49	2.01	1.82	0.56	0.31	1.79
1981	10.85	4.20	6.67	2.07	1.82	0.63	0.28	1.87
1980	11.02	4.26	6.78	2.14	1.84	0.66	0.21	1.93
1979	11.37	4.46	6.94	2.19	1.81	0.67	0.16	2.11
1978	12.08	5.01	7.10	2.21	1.82	0.67	0.16	2.23
1977	12.15	5.17	7.02	2.14	1.77	0.64	0.15	2.32
1976	11.98	5.17	6.85	2.10	1.65	0.56	0.16	2.38
1975	11.74	5.09	6.68	2.07	1.57	0.55	0.15	2.34
1974	11.93	5.16	6.81	2.07	1.57	0.55	0.11	2.51
1973	12.41	5.43	7.01	2.04	1.60	0.56	0.09	2.72
1972	12.24	5.51	6.77	1.99	1.47	0.50	0.09	2.72
1971	11.50	5.26	6.27	1.88	1.24	0.42	0.09	2.64
1970	11.32	5.07	6.29	1.86	1.20	0.49	0.09	2.65

Note: Revenue for each fiscal year is divided by personal income in the calendar year that ended during it.

Sources: For tax revenue, U.S. Census Bureau, *State Government Finances* (Washington, D.C.: U.S. Government Printing Office, various years). For personal income, U.S. Department of Commerce, *Survey of Current Business 67* (August 1987): 44; U.S. Department of Commerce, *Survey of Current Business 68 (August 1988)*: 30

CHAPTER 2

THE EVOLUTION OF SCHOOL FINANCE IN THE LATE 1980s AND EARLY 1990s

During the late 1980s, school finance activity was generally sluggish despite the fact that concern about the funding of elementary-secondary schools was cited repeatedly as the most important education issue on the minds of state legislators. In 1990, this situation changed dramatically as school finance litigation mushroomed, states initiated studies of school finance systems, and new formulas were implemented in several states. The early 1990s are likely to remind policy makers of the period in the early 1970s when school finance litigation was rampant and states were deeply involved in reviewing and changing their school finance formulas.

School finance in the late 1980s

There are a number of reasons why the late 1980s were relatively quiet as far as school finance is concerned.[1] First, with the release of *A Nation at Risk* in 1983, the attention of policy makers was directed toward school improvement, excellence and restructuring and away from concerns about interdistrict fiscal equity. The initial response to the federal report was a flurry of other national, state and local studies and reports, each of which drew similar conclusions about the need to improve pupil performance and made a host of recommendations about the most effective way to achieve that goal. Initially, it was suggested that schools could be improved with little additional expenditures by raising expectations, using time more efficiently and improving assessment practices. The first "wave" of reform, targeted primarily on increasing teachers' salaries and providing more education services (by lengthening the school day or the school year, reducing class size and providing more course offerings) was implemented with a moderate level of new expenditures.[2]

In order to accomplish significant restructuring of the schools, however, more funds may be needed, particularly if new instructional arrangements are implemented, if the use of technology is expanded

...with the release of A Nation at Risk *in 1983, the attention of policy makers was directed toward school improvement, excellence and restructuring and away from concerns about interdistrict fiscal equity.*

A second reason why school finance activity in the late 1980s was so lethargic is that school finance litigation was all but invisible.

Third, school expenditures were growing at levels well ahead of inflation in most, but not all, states, while state support was providing a larger share of total expenditures.

significantly and if the transformation of the teaching profession continues.[3] With so much attention focused on developing and implementing approaches designed to improve pupil performance, it is hardly surprising that there was little political capital available to modify school finance systems. Past experience suggests that a significant commitment of a state's political resources, as well as a state's revenues, are needed to change the way a school finance system works, particularly if the change results in large numbers of districts that lose state aid.

A second reason why school finance activity in the late 1980s was so lethargic is that school finance litigation was all but invisible. Between 1970 and 1983, over half the states were involved in court cases testing the constitutionality of school finance systems. This activity resulted in the school finance systems of seven states being found unconstitutional (California in 1971, New Jersey in 1973, Connecticut in 1975, Washington in 1977, Wyoming in 1980, West Virginia in 1982 and Arkansas in 1983), providing a constant reminder to policy makers about the vulnerability of their school finance decisions.

This litigation also stimulated numerous states to evaluate their school finance structures and, in some cases, to devise new approaches in the early 1970s (as in Colorado, Kansas and Minnesota). Between 1984 and the beginning of 1989, no school finance systems ran afoul of legal requirements, providing a five-year cushion that lulled observers of the school finance scene into thinking that litigation might not be a threat in the future.[4]

Third, school expenditures were growing at levels well ahead of inflation in most, but not all, states, while state support was providing a larger share of total expenditures. Between 1982-83 and 1987-88, per-pupil expenditures increased by 17.2% above inflation, growing from about $3,000 per pupil to over $4,200 per pupil. During that period, the average per-pupil expenditures of all but seven states grew faster than inflation.[5] At the same time, the states had increased their share of school revenue from 48.4% in 1982-83 to 50.0% in 1987-88, continuing a long-term trend. While there was still some variation among the states, by the late 1980s 14 states provided over 60% of all revenues for the public schools, while only nine states provided less than 40% of all revenue.

Finally, the late 1980s generated little in the way of innovation in school finance, and what new ideas were developed were not disseminated widely. Between 1986 and 1989, several states fundamentally changed their school finance structures, often reverting to approaches that are widely used in other states or that previously had been used in the state making the change. For example, in 1987, Vermont created a new foundation program to replace its percentage equalizing system. Under this system, the state is required to set the foundation level based on the cost of providing those services mandated by the state.

In 1988, Colorado passed HB 1341, which devised a multi-level foundation approach to replace the guaranteed yield system that had been in place since 1973. Under the new system, each of the state's 176 school districts is placed into one of eight "setting categories" designed to group districts based on spending levels and characteristics thought to affect spending levels such as population or location. While every district must make the same property tax effort, each group has a different foundation level. In addition, districts are limited in the extent to which they can supplement foundation revenue; no district can provide more than 7.5% of its foundation level in local leeway

above the foundation level.* As part of the new approach, the state also implemented an indirect approach to recapture revenue from very wealthy districts by deducting excess local revenue generated under the foundation program from state aid that would otherwise be provided for special education or transportation expenditures.

The resurgence in school finance activity of the early 1990s can be attributed to several factors, not the least of which is the recent success of challenges to the constitutionality of state school finance statutes in Montana (1989), Kentucky (1989), Texas (1989) and New Jersey (1990).

Other states also implemented new school finance systems in the second half of the 1980s. In 1986, South Dakota created a "reward-for-effort" formula designed to allow districts to choose their own expenditure levels while assuring them of an equal yield for their tax effort (with the exception that districts choosing very high levels of expenditure are required to make relatively greater effort). Under South Dakota's system, districts with low enrollment are allowed to make a smaller tax effort to raise the same amount per pupil as a larger district, which lets them choose a higher revenue level at a similar tax rate.

Also in 1986, Georgia enacted its Quality Basic Education Act, a two-tiered system combining a foundation program with a guaranteed tax-base approach. Using this system, the state assures every district that for the first 3.25 mills of property tax effort above the five mills required for participation in the foundation program, the district can generate the same amount per pupil as the district with property wealth at the 90th percentile of all districts.

One of the most interesting innovations of the late 1980s was the declining enrollment "matrix" introduced in Iowa in 1989. It followed a study of the school finance system undertaken in anticipation of the state's "sunset" provision. Iowa has had one of the largest decreases in enrollment of any state; between 1978-79 and 1988-89, Iowa lost 16.0% of its enrollment compared to a national average decrease of 5.8%. Under the old system, the enrollment guarantee for every district was 25% of the 1978 enrollment plus 75% of the enrollment one or two years prior to the current year. This approach created enormous numbers of "phantom" pupils. Using the declining enrollment matrix, both the magnitude of annual enrollment change and the relative time when the change took place (from one to five years ago) are used to determine an adjusted enrollment count. This approach is based on the economic impact of declining enrollment rather than on the mathematics of multi-year enrollment averaging, the most typical method used by states to increase revenues for districts educating fewer pupils.

Factors stimulating renewed interest in school finance

The resurgence in school finance activity of the early 1990s can be attributed to several factors, not the least of which is the recent success of challenges to the constitutionality of state school finance statutes in Montana (1989), Kentucky (1989), Texas (1989) and New Jersey (1990). In Montana, the primary issue was that the state's foundation program was operating at a level well below the average expenditure of districts. Also, the amount of local funds raised above the foundation program was driven by the property wealth of districts.

In Kentucky, the court declared all education statutes to be unconstitutional after determining that the evidence presented indicated that factors in addition to the funding system resulted in both wide disparities among all districts and inadequate services in some districts, in violation of the state constitution's education clause. In Texas, the court found that the school finance system was not fiscally neutral and that the

foundation program did not provide sufficient funding to meet state program requirements. The result was a system that was inefficient, both fiscally and programmatically.

In New Jersey, the state supreme court ruling followed a tortuous nine-year odyssey through the courts, an administrative law judge and a ruling by the state's education commissioner. The primary issue was the ability of urban school districts to take advantage of the state's percentage equalizing program, which provided more state aid to districts willing to make a higher property tax effort. The state supreme court ultimately found that the needs of the state's urban school districts were comparatively high but not being met, and that the management procedures put into place to assure that education was provided in a "thorough-and-efficient" manner were insufficient.

The generic issues raised in these cases were similar to those that inspired New Jersey litigation two decades ago. Plaintiffs were concerned about the disparity in per-pupil revenue across school districts and in the relationship between the revenue and wealth of school districts. They also were disturbed by the provision of insufficient funds to meet state standards and mandates. Plaintiffs argued that money makes a difference, that is, districts with more funds offer a richer array of courses, have lower pupil-teacher ratios, are able to hire better-qualified teachers, employ more ancillary personnel and have more modern facilities and equipment. The defensive posture is that the availability of money is unrelated to the performance of pupils, that a variety of factors explain spending differences among school districts, that the state is only responsible for assuring some basic level of revenues and that local control allows revenue differences that are based on variations in tax rates.

Such cases are decided primarily on the basis of interpretations of state education clauses, which may require that education be provided in a "thorough," "efficient" or "ample" manner, although equal protection issues also are applicable. In many cases where a school finance system is found to be unconstitutional, the court declares that education is a fundamental right and that there is a better way for the state to distribute aid to school districts in light of their widely varying needs and fiscal capacities.

Other elements, in addition to litigation, have stimulated the recent tumult in school finance. First, there is a sense that the school finance activity of the last 20 years has not accomplished as much as was hoped in terms of improvements in interdistrict fiscal equity. Some of the early analyses of the impact of school finance reform suggested that more attention was paid to taxpayer equity than to pupil equity. Continuing frustration with the slowness of improvements in equalization manifested itself in the introduction of the HR 3850, the Fair Chance Act, by Congressman Hawkins of California in 1990. This bill would prohibit the distribution of federal funds to states that do not meet very strict per-pupil expenditure disparity standards (no more than a 5% variation is recommended) and provide funds to equalize the per-pupil spending variation between states.[7]

Second, some of the new funds provided by states to improve education may be disequalizing, since they do not consider the fiscal capacity of districts. For example, when states fully fund the costs of implementing career ladders for teachers, the result can be that more state aid flows to wealthy districts than to poor ones, because the wealthy districts attract teachers who attain higher levels on the career ladder, entitling them to

more state aid. This is not very different from the use of teacher training and experience factors in state aid formulas, which results in more state funds going to wealthy districts that tend to have higher proportions of teachers with master's degrees and more years of experience. The difference is that the amount of money associated with the implementation of career ladders may be substantially greater than state support for training and experience.

Finally, many state aid systems are getting old, making them less sensitive to the environment within which they operate. As state demographics change, a system designed to deal with differences of a particular magnitude in property wealth or enrollment, for example, may not work as well when the magnitude increases. Foundation programs, the most popular school finance mechanism used by states, are particularly susceptible to problems associated with aging. This occurs because foundation levels do not increase as rapidly as the cost of meeting state mandates escalates or because required local effort is set at a particular level to meet the political needs of one time, but does not grow and meet the needs of another time.

School finance activity in 1990

In 1990, school finance activity occurred on multiple fronts: in the courts, in the implementation of new systems and in studies of existing systems. The court cases in Montana, Kentucky, Texas and New Jersey, along with the multitude of new cases that have been filed or are being contemplated, are recreating the atmosphere of the early 1970s. (As of November 1990, cases were in progress in Alabama, Alaska, California, Idaho, Illinois, Indiana, Kansas, Massachusetts, Michigan, Minnesota, Missouri, New York, North Dakota, Oklahoma, Oregon, Rhode Island and Tennessee, while they are being considered by potential plaintiffs in other states.)

...as of November 1990, cases were in progress in Alabama, Alaska, Idaho, Illinois, Indiana, Kansas, Massachusetts, Michigan, Minnesota, Missouri, North Dakota, Oklahoma, Oregon, Rhode Island and Tennessee,...

While the decisions in Montana and Texas were fairly traditional, the decision in Kentucky raises the possibility that school finance litigation can bring the entire structure of the education system under scrutiny. The New Jersey litigation demonstrates that it is possible to focus a case on the way a school finance system affects some, not all, school districts. States are justifiably nervous about the possibilities of future litigation.

In 1989 and 1990, Montana, Kentucky, New Jersey and Texas enacted new school finance systems designed to overcome the problems that had been identified in litigation. Montana passed HB 28, which raised the mandatory statewide property tax millage from 45 to 95 mills, correspondingly raised the foundation level and placed a 35% limit on how much school districts can generate above the foundation level.

Under HB 940, the Education Reform Act of 1990, the Kentucky General Assembly will distribute funds to the state's 177 districts (the number of districts was not changed by the legislation) using a foundation program in conjunction with a guaranteed yield program. The guaranteed yield program covers revenues up to 15% above the foundation program and applies to districts with wealth less than 150% of the statewide average. While districts may raise local funds beyond 115% of the foundation level, they are limited to generating no more than 149.5% of the foundation level.

Kentucky also established a foundation program for capital outlay and debt service. While the state will continue to use a statewide salary schedule, by 1992-93 a new professional compensation plan, with

Unlike most states, under the new system New Jersey equalizes payments for the teacher retirement program and Social Security.

an emphasis on teacher evaluation, is to be developed. The school finance system is to be reviewed by the Office of Education Accountability, a new office of the Legislative Research Council.

One of the most innovative components of the new system is that it will provide fiscal incentives to schools in which pupil performance improves. The state set aside funds for that purpose, although they will not be distributed until pupil performance is defined and measured. From the perspective of funding, the most important shift in Kentucky is from state control over how districts spend money to the specification of what the state wants the education system to produce and the provision of sufficient funds to accomplish those ends.

In Texas, the legislature passed SB1 during the fourth special session called to respond to the court's decision. Under the new law, an equity standard was established that requires substantially equal access to similar amounts of state and local revenue per pupil, when districts have similar tax efforts, for districts enrolling 95% of the state's pupils. The state continues to use the formula structure first implemented in 1984, which includes a foundation program and a second tier, with significant enrichment of the parameters that drive the formula (for example, the foundation level was raised from $1,477 per pupil in 1988-89 to $1,910 per pupil in 1990-91).

SB1 also gives much greater responsibility to several legislative groups to develop formula parameters and to calculate certain technical adjustments to the formula. For example, the Legislative Budget Board and the Legislative Education Board (each of which have 10 members, four of which are overlapping) are required to develop the foundation level, pupil weights to adjust for programmatic costs, a cost-of-education index, an adjustment for enrollment level and a set of standards by which to evaluate the equity of the system (previously, some of this information was developed by the Texas Education Agency). Ultimately, the recommendations of these boards must be approved by the Foundation School Fund Budget Committee composed of the governor, the lieutenant governor and the state comptroller.

In September 1990 the court found that SB1 did not fulfill constitutional requirements beyond 1990-91 and gave the legislature one year to devise an appropriate remedy.

New Jersey's new system, the Quality Education Act of 1990, was passed by the legislature less than two weeks after the court's decision. Under the act, a foundation level of revenue which differs based on the grade span served by the district is established for all districts. Under the foundation program, districts must make a specified tax effort determined by both their property wealth and personal income levels, although only property is actually taxed. Districts may choose to obtain less revenue than the foundation amount, but only if their pupils are performing at reasonable levels.

Unlike most states, under the new system New Jersey equalizes payments for the teacher retirement program and Social Security. Traditionally, states pay the full share, or most, of the contributions toward state teacher retirement programs. In some states, particularly those that use statewide salary schedules and whose foundation programs specify the number of personnel to be employed by districts, state contributions may be limited to specific numbers of employees or specified salary levels, with districts responsible for the costs associated with supplemental personnel or supplementary salaries. Minnesota equalized support for its teacher retirement program in 1989, raising its

foundation level to cover such costs.

Other states also passed new school finance systems in 1990 without the stimulus of a court. Under LB 1059, Nebraska's Tax Equity and Educational Opportunities Support Act, every school district is placed into one of several "tiers" based on grade span and enrollment level, each of which has a different designated foundation level. Districts are rebated 20% of the income taxes collected by their residents. Each district's share of the foundation program is the sum of its income tax revenues and the yield of a specified property tax rate. The new law places limits on the extent to which district budgets may increase without a vote of the people. Under Nebraska's referendum procedure, the new school finance system was subjected to popular vote in November 1990, and the voters upheld its use.

Several states initiated major studies of their school finance systems in 1989 that are likely to lead to changes in the structures of their school finance formulas in 1990 and 1991.

Following the completion of work of a special task force established by the Oklahoma legislature, HB 1017 was passed. It added a significant amount of resources to the system (all districts were at the constitutional limit of their property taxes so that revenue growth was stimulated only by increases in property valuation or state aid, neither one of which had been occurring). HB 1017 also improved the consistency of the formula that had been in effect for nearly a decade (by using similar pupil counts and weights in both "tiers" of the system) and called for very high nonresidential property value to be taxed on a statewide basis (this was subsequently turned down in a referendum). As part of HB 1017, a study group was established to review the pupil weights used to adjust state aid for the high costs associated with certain programs (such as special education) and characteristics of school districts (such as size).

Several states initiated major studies of their school finance systems in 1989 that are likely to lead to changes in the structures of their school finance formulas. For example, in Wisconsin, the Governor's Commission on Schools is examining the entire structure of public education in the state, and a subcommittee on school finance has been established to review the funding of education.

In April, Louisiana's State Board of Elementary and Secondary Education (BESE) adopted in principle the recommendations of its School Finance Advisory Council to redesign the school finance system. Unlike in any other state, BESE has the responsibility to develop and adopt a state aid formula that becomes effective once the legislature approves it. If the legislature approves the formula recommended by BESE, it is required to fully fund it; if it does not approve the formula, it may recommend changes to BESE, but if agreement cannot be reached the legislature must then accept the last formula adopted by BESE and approved by the legislature.

The current minimum foundation program uses approved staffing ratios and a statewide teacher salary schedule with very little local support required of local districts. The new approach would replace it with a pupil-weighted multi-level system under which much of the funds currently raised by local property and sales taxes would be considered as a chargeback under the first level. Relatively poor districts would be able to supplement first-level revenue, supported by state aid, if they made a tax effort above that required in the first level. The fiscal capacity of districts would be determined by a combination of both their property wealth and sales tax collection potential, using a Representative Tax System approach (as used by the Advisory Commission on Intergovernmental Relations).

Utah's State Office of Education created a School Finance Study Task Force that engaged in a year-long study of school finance. Its

recommendations were to be presented in fall 1990, following public hearings. The task force is advocating a number of changes in the state's two-tiered school finance system (a foundation program with a required local property tax and full recapture and a guarantee that districts can generate a specified percentage of the foundation level per pupil, per mill of property tax effort up to a specified number of mills beyond those required in the foundation program). Those changes include: (1) the merger of several special purpose programs currently funded separately under the foundation program; (2) a limitation on the extent to which districts may generate second-tier funds, based on a proportion of the first tier rather than a tax-rate limitation; (3) expanded equalization of second-tier funds so that all districts have the same opportunity to raise funds up to the limit; (4) equalization of state aid for the career ladder program, which is fully paid by the state; (5) equalization of Social Security and retirement funds, which are supposed to be paid completely by the state; and (6) equalization of capital outlay and debt service millages, for which the state provides very little current support.

In both Illinois and Ohio, legislative committees have been given the responsibility to evaluate the school finance system and to make recommendations to the legislature for consideration in the 1991 sessions.

Conclusion

In the next few years, school finance activity in the states is likely to grow as litigation focuses attention both on the inequities across school districts in particular states and the lack of sufficient funds to provide high-quality education services. There has always been a tension between the adequacy and equity issues. This tension will continue in the future and become complicated by questions about the efficiency of the education enterprise and the role of local control in its management. Both because the enterprise is so large and because it continues to be perceived as producing less-than-expected results, politics at the local, state and federal levels will permeate decisions about education and particularly about the financing of education. Ultimately, the focus of much of this attention will continue to be the mechanisms used by states to distribute funds to school districts.

NOTES

1. For example, see Mark Weston and Karen Walker. *State Legislative Report*. Denver: National Conference of State Legislatures, Vol. 13, No. 3, January 1988.

2. This is not to say that there was absolutely no activity in the school finance arena. Some school finance litigation was under way in a few states, although no final decisions were announced by state supreme courts. A few states reviewed their formulas during this period. However, the situation was comparatively quiet.

3. Odden, Allan. *The Economics of Financing Education Excellence*. University of Southern California, April 1987.

4. McGuire, Kent and John Augenblick. *The Costs of Restructuring Schools* (for the National Governors' Association, July 1988).

5. In the second half of the 1980s, school finance systems were upheld in California, Connecticut, Florida, Louisiana, New Jersey, Oklahoma, Pennsylvania, Texas and Wisconsin, either by a state's lower court or its supreme court. Michael W. La Morte. *Courts Continue to Address the Wealth Disparity Issue*, for the National Organization on Legal Problems in Education (November 1988).

6. Augenblick, John. *Key Points about School Funding at the End of the 1980s and How it Has Changed in the Last Decade*. Denver: Augenblick, Van de Water & Associates, 1989.

7. When the law was originally passed, the limitation was 5%.

8. See the transcript of the Hearing on H.R. 3850 (Jan. 24, 1990), U.S. Government Printing Office, Serial No. 101-69, Washington, D.C., 1990.

Table 7

Summary of School Finance Litigation in the States*

States in Which the School Finance System Has Been Found to be Unconstitutional by the State's Highest Court	States in Which the School Finance System Has Been Challenged and Upheld by the State's Highest Court	States in Which the School Finance System is Currently Being Challenged
Arkansas (1983)	Arizona (1973)	Alabama (filed in 1990)
California (1971)	Colorado (1982)	Idaho (2 filed in 1990)
Connecticut (1977)	Connecticut (1985)	Illinois (filed in 1990)
Kentucky (1989)	Georgia (1981)	Indiana (filed in 1987)
Montana (1989)	Idaho (1975)	Kansas (filed in 1990)
New Jersey (1973, 1990)	Maryland (1983)	Massachusetts (filed in 1990)
Texas (1989)	Michigan (1984)	Michigan (2 filed in 1990)
Washington (1978)	New York (1982)	Minnesota (filed in 1988)
West Virginia (1982)	Ohio (1979)	Missouri (filed in 1990)
Wyoming (1980)	Oklahoma (1987)	North Dakota (filed in 1989)
	Oregon (1976)	Oklahoma (filed in 1990)
	Wisconsin (1989)	Oregon (filed in 1989)
		Rhode Island (filed in 1990)
		Tennessee (filed in 1988)

* This table only includes state court activity. It does not include federal court activity. Any decision upholding the constitutionality of a system delivered prior to a subsequent declaration by a state supreme court that the system was unconstitutional is not shown.

Note: In some states cases have been filed that are inactive (as in Alaska), a case has been filed that only indirectly affects the state's school finance system (as in Ohio), or a case was filed but dropped by plaintiffs after a new school finance system was enacted (as in Colorado).

Table 8

Characteristics of Significant Changes in State School Finance Systems Since 1985

Characteristic	State
1. Shifted from a "reward-for-effort" approach to a "foundation" approach	Colorado Connecticut New Jersey Vermont
2. Shifted from a "foundation" approach to a "reward-for-effort" approach	South Dakota
3. Made the system sensitive to the tax effort of school districts	Georgia Kentucky New Hampshire
4. Included income in the determination of school district fiscal capacity	Nebraska New Hampshire New Jersey
5. Included a direct or indirect method of "recapturing" state aid from very wealthy school districts	Colorado
6. Developed an accurate system to account for the fiscal impact of declining enrollment	Iowa
7. Implemented a pupil-weighted system to account for the high costs of specific education programs and services	Arizona
8. Placed absolute limits on the per-pupil spending levels of school choice	Colorado Kentucky Montana
9. Equalized the teacher retirement program	Minnesota New Jersey
10. Created a system of evaluating the equity of the school finance system	Colorado Kentucky Nebraska Texas
11. Implemented a cost-of-education index to reflect geographic cost difference	Ohio
12. Moved from classroom unit to a pupil-unit driven formula	Mississippi

CHAPTER 3

ISSUES FOR THE 1990s

A critique of current finance policy

Although the latter part of the 1980s saw an increased interest in school finance policy (over a third of the states have had some kind of activity), one glaring observation is that not much has changed. States approach education finance today just as they did 20 years ago. There have been few new approaches to dealing with the problems that school finance structures are expected to address.

Paying attention to traditional issues in school finance

There are a number of ways that the bias against innovation and change in school finance can be illustrated. For example, school districts in the United States continue to vary dramatically in size and enrollments, yet most of the adjustments for dealing with cost differences due to district size are fairly mechanical[1] and unrelated to evidence on relationships between size and costs. For purposes of allocating extra state aid, a common adjustment is to eyeball data on expenditures, see how that data varies with district/school size and make arbitrary distinctions among districts. The blame for these inexact adjustments may lie with the research community, which has done little to translate research findings into practical and politically understandable ways of making these adjustments.

Also remarkable is the inattention most states give to resource price differences. It is generally accepted that prices for education resources (teachers, instructional materials, fuel, facilities, etc.) will vary for a number of reasons, such as geography and location. To date, however, only six states make any kind of state adjustments that account for these price differences. Admittedly, the theoretical and technical issues that undergird efforts to measure these price differences contribute to the

problem.[2] But the absence of any effort to address price differentials, which research indicates can be as great as 25%, undermines the efficiency of most state aid systems.

The way state finance systems approach enrollment fluctuations, differences in costs due to service requirements, and the way they measure local ability to provide revenue for schools are other examples of lack of innovation. Although the weaknesses associated with current practice are well documented,[3] the approaches for addressing these special characteristics of districts and students remain for the most part unchanged. These concerns about current practice in school finance underscore the importance of dealing vigorously with a series of longstanding issues.

Although studies have been conducted in Illinois, Alaska and Connecticut, no state has actually implemented a financing system based on the program cost modeling technology.

Costs. The vast majority of states, particularly those using the foundation program approach, key their aid payments to some indicator of costs. Methods used to determine costs have been around for some time. Standard cost accounting techniques use historical expenditure data as their basis. One criticism of this approach is that it provides only information about what has happened in the past, not about desired spending. Another approach involves the development of program cost models. The rationale is that what matters in determining costs are the resources employed in delivering services and how these resources are deployed.[4] A program cost model, it is suggested, provides a framework for identifying and sorting out the factors underlying differences in education costs across school districts.

The issue is how to replace arbitrary foundation or guaranteed yield levels and the need, cost and scale factors found in conventional school finance formulas.[5] The challenge is political in nature. Although studies have been conducted in Illinois, Alaska and Connecticut,[6] no state has actually implemented a financing system based on the program cost modeling technology. Given the programmatic reforms of the 1980s and the continuing emphasis on school restructuring, it stands to reason that the cost of schooling will receive considerable attention in the 1990s.

Fiscal capacity. Next to costs, fiscal capacity is the most prominent factor in state school finance formulas. In fact, the main function of such formulas, apart from distributing a certain fraction of total support for the schools, is generally agreed to be that of equalizing for differences in fiscal capacities among school districts (localities). Researchers have pointed out that using only the assessed valuation of property is not a particularly good measure of ability to pay for schools. Districts with the same property values but unequal incomes have unequal abilities to export portions of their tax burden to nonresidents, and hence different fiscal capacities.[7] Several empirical studies have shown that income and the composition of the property tax base exert independent effects on local spending behavior, implying that a capacity measure that takes these factors into account might be a better measure than property value alone.[8]

However, very little effort has been given to expanding existing measures or to investigating the impact of alternatives. Instead, the debate in the states has been over whether local property taxes should continue as a source of revenue for schools. Some argue that because the value of one's home or business is not realized until it is sold, taxing property is inefficient and unfair. Property tax opponents often suggest that since income is what

people use to pay their taxes, it is a more appropriate measure of local wealth.

Proponents of property taxes call for its improved administration. Property, they argue, is as good a measure of wealth, and hence fiscal capacity, as income or other measures and may even be easier to measure. Less subject to short-term fluctuations in economic activity, property taxes are considered by supporters as more reliable than other revenue sources. Expect this debate to continue, particularly if rising costs place upward pressure on local tax rates.

A more general criticism of contemporary finance systems might be that they are often a hodge-podge of inconsistent programs and strategies. One part of the state finance system seeks to equalize expenditures. Another provides large amounts of categorical aid, ignoring the equity principles pursued in the "general formula."

Price Differences. The idea that state aid payments should be adjusted to reflect geographical variations in resource prices is widely accepted in principle. The implementation of this idea has been slow, mostly due to the difficulty in constructing satisfactory price indices. Literature on the subject of education cost differentials accumulated during the 1970s, and a number of efforts were made to develop cost indices based on these studies.[9, 10, 11] These studies generally indicate that school districts do face different resource prices due to differences in market conditions and other factors beyond the control of local officials. What may be needed here is a new round of studies designed specifically to compare the results of alternative ways of identifying resource price differences (e.g., the relationship between cost-of-living and cost-of-education indices).

Pupil need. Finally, there is the tradition that extra funds be allocated to districts that serve disadvantaged, handicapped or other special-needs children. There are two issues here.

The first concerns who is "special." State aid systems now have so many definitions of pupils that distinguishing between the educationally disadvantaged, at risk, learning disabled or emotionally disturbed is problematic. Misclassification is frequently a concern of state policy makers who believe districts intentionally identify children into various categories to generate extra revenue. Meanwhile, district officials lament the numerous state mandates for serving the special needs population in the absence of full state funding.

This gets to the second issue — accurately measuring need. Research on need factors has concentrated mainly on special education and has focused on estimating cost differentials.[12, 13] The weights applied to multiple categories of handicapped children under state aid systems are apparently derived from such estimates. Again, there is a logical problem with this approach — using actual cost differentials rather than differentials based on what "should" be spent.

Practically speaking, some reconsideration of who is in the special student category may be needed if states are to continue their support of these services on a per-student basis. Nor will policy makers avoid a re-examination of the mandated services, particularly in light of proposals for changing the relationships between schools and other youth-serving agencies. The costs and funding streams associated with these new relationships could be quite different.

Inconsistent finance policy

A more general criticism of contemporary finance systems might be that they are often a hodge-podge of inconsistent programs and strategies. One part of the state finance system seeks to equalize expenditures. Another provides large amounts of categorical aid, ignoring the equity principles pursued in the "general

formula." Some state aid systems require only small local contributions to qualify for aid. Others do nothing to equalize local ability to spend above the amounts generated through their formulas. These internal inconsistencies limit the overall equalizing potential of state school finance systems. They also raise a number of interesting questions about finance policy now and in the future.

Emerging reform policy... includes ideas such as greater flexibility and discretion in deciding how to use funds, the commingling of funds across diverse student groups or school functions, linking continued or increased funding to outcomes rather than compliance and even the provision of incentives tied to local or private sector contributions.

Considering what is equalized. If school funding systems are to be consistent, policy makers might need to pay more attention to the state aid that is equalized and the aid that is not equalized. Some believe there are only a handful of functions that should be treated outside basic state equalization formulas. Frequently mentioned examples include transportation and capital outlay. The rationale is that these functions are unique to local circumstances and should be addressed accordingly.

Keeping functions such as transportation outside the basic aid structure does not mean they cannot be equalized, and some believe that all forms of state aid should consider local ability to pay. A few states have developed separate equalization formulas for these functions. In a majority of states, however, capital outlay and transportation are handled categorically. The growth in new categorical programs (i.e., at risk, early childhood) makes this question of what is equalized important, because the funding for those programs can be significant.

What is needed are rules of thumb or criteria upon which to make these kinds of decisions. For instance, deciding whether or not to equalize a certain kind of state aid might need to depend on factors such as:

- Do all school districts receive this particular form of aid?
- Is this an ongoing function or temporary support?
- How significant is this allocation in relation to the total revenue available?

It might be that when all districts qualify for particular aid, when the function or activity is considered regular and long term, and when the dollars involved are significant in relation to total revenue, then the aid should probably be equalized — either with other functions or separately (i.e., as might be necessary for capital projects).

Considering the relationship between equity and quality. The other key issue raised in this concern for coherent state finance policy is the interaction between policy goals related to equity and those goals related to school quality. State goals related to equity typically call for students or districts to be treated the same. For instance, many finance systems strive for equal expenditures per pupil, place limits on local ability to spend above state-determined levels and focus on compliance with strings tied to the use of funds on specific student populations or school activities.

Emerging reform policy, on the other hand, includes ideas such as greater flexibility and discretion in deciding how to use funds, the co-mingling of funds across diverse student groups or school functions, linking continued or increased funding to outcomes rather than compliance and even the provision of incentives tied to local or private-sector

contributions. Attempts to promote qualitative improvements in schools through finance policy raises these questions:

- Does the state place a ceiling on total spending in the name of equity when (1) the policies for qualitative improvements encourage the attainment of resource-abundant programs and activities and (2) where the true costs of such improvements or innovations are not well known?
- If local matching funds, public or private, are associated with a policy related to qualitative improvement, are limits placed on the fund-matching capacities of districts or schools in the name of equity?
- If incentives are provided to increase local effort in support of schools, but only wealthy districts take advantage of them, what is the state response in equalizing opportunity for less wealthy districts?
- What forms of control does the state exercise over the use of funds associated specifically with qualitative improvements at the local level? Do traditional requirements such as "supplement not supplant" still work? What happens to state allocations when local implementors spend "less" than was allocated? Do the funds revert back to the state, or do local policy makers get to reallocate those resources to other program areas?

There are no clear answers to these questions. Reform proposals funded without regard for equity considerations are probably destined for uneven implementation and poor success.[14, 15, 16] On the other hand, where reform means fostering differences — in approaches to reform, in strategies of implementation and in costs and expenditures, which appears to be the direction at present — then strict controls over the level and use of funds may need to be relaxed in hopes of achieving greater productivity in the schools.

For certain, these are among the new challenges for finance policy in the 1990s. In fact, it makes sense to carefully examine the current reform agenda and review what it might portend for school finance policy over the next few years.

The convergence of school finance and school restructuring

While a great deal of attention should be focused on improving the basic aid structures and the associated technical problems, other issues are driving the renewed interest in school finance. As school reform continues, questions about the costs of restructuring and the role of the state in stimulating such basic change in the schools have arisen.

The issues range from the nature of the accounting systems used to track and report fiscal information to the role of the school finance system in school-site budgeting. Increasing legislative interest in the use of fiscal incentives also is stimulating questions about the basic structure of school finance systems and the extent to which the state should reimburse districts for their expenditures or reward them for performance of their pupils.

If there is a consensus on the substance of education reform, it seems to be developing around four broad and overlapping themes. First and foremost, schools must *raise the distribution of achievement through new methods of teaching*. If students were achieving at acceptable levels, graduating at acceptable rates and

...there has never been much evidence suggesting that teacher training and experience are associated with student achievement, yet nearly a quarter of the states link aid allocations to these characteristics of teachers. Moreover, there are few incentives built into finance systems to reward school success or to increase student achievement. Instead, pupil-based funding systems provide incentives to count pupils and increase attendance.

demonstrating competencies considered important in higher education or business environments, then there would be no need to restructure. But because only a small proportion of high school graduates acquire the knowledge for today's workplace, improved teaching and learning is the central challenge before the public schools.

How the schools are restructured to improve teaching and learning is debatable, but presumably the emphasis will be on changing things that influence the delivery of instruction or that are in some way associated with increased learning. The way students are grouped for instruction or the way time is allocated and used during the school day or week are often-used examples.

Reformers also talk about altering the number and mix of personnel and other resources involved in instruction. There are any number of possible modifications to the way schools are organized and managed with the hope of producing better learning.

A second theme has to do with *enhancing the institutional competence of schools*. This has come to mean a number of things — fostering the professional growth of teachers, providing time and structures for school staff and students to pay attention to real problems and opportunities in the schools, and allowing school staff, particularly teachers, to play a greater role in the day-to-day operation of schools. In fact, much of this agenda has focused directly on teachers. A number of recent collective bargaining agreements create opportunities for teachers to share in setting school policy, assist in the evaluation and review of their peers and assume positions of leadership without having to leave teaching. Pilot initiatives in several states provide incentives for similar school or district-based initiatives.

The third theme, very closely linked to the second, has to do with *decision making and governance in schools*. Reformers argue that schools are in the best position to decide how to use the resources at their disposal. So schools should decide which services (such as testing or curriculum specialists) to purchase from the central district or from other sources. Schools should be the locus of decision making for curriculum and instructional materials. Individual school staff should make decisions about teaching techniques. They should determine their staffing needs and how to fill them. And they should make choices related to the professional development opportunities available. Truly restructured schools will find new ways to involve parents, community organizations and the business community in setting goals, implementing programs and garnering resources, both money and expertise.

Finally, there is a desire to shift *the incentive structure that drives behavior and resource allocation in schools*. For most reformers, this starts with developing new forms and mechanisms of accountability. Advocates suggest that the manner in which schools and the people who work in them are held accountable for student performance matters a great deal. It has been suggested that schools should develop assessment strategies designed to measure problem solving and cognitive development. And rewards and sanctions should be linked to these "robust" outcome measures so that the consequences of success and failure are clear and direct.

Education reform and its relationship to school finance

One of the present criticisms of school finance policy is that it remains almost completely unrelated to policy on education reform and change in the

Current finance policy in most states is almost entirely unrelated to policy concerned with school effectiveness and reform. Given that state finance systems often govern the use of the vast majority of resources for the schools, building connections between the distribution of funds and information on what works in districts and schools would seem to make sense.

public schools. Many feel that finance systems work in opposition to efforts to change and improve the schools and that the incentives built into current school finance systems run counter to policies related to school improvement. For instance, there has never been much evidence suggesting that teacher training and experience are associated with student achievement, yet nearly a quarter of the states link aid allocations to these characteristics of teachers. Moreover, there are few incentives built into finance systems to reward school success or to increase student achievement. Instead, pupil-based funding systems provide incentives to count pupils and increase attendance.

Considering the four themes that characterize current reform initiatives, there are at least two important challenges or tasks that state and local policy makers are likely to confront in the 1990s:

- Rethinking or redesigning mechanisms for the distribution of state funds
- Modifying or expanding the accountability and control framework typically associated with school finance policy

Rethinking mechanisms for distributing state aid. The basic finance structures used by the states could be improved in many ways. Better cost indicators, better measures of relative need and of local ability to pay and more attention to the relationships between different parts of a state school finance strategy would help. But in terms of finance and its relationship to school reform, the question is how traditional forms of distribution in school finance are affected by efforts to restructure the schools.

First, current notions of school reform emphasize the school as the unit of change and improvement. State finance systems operate, for the most part, from state-district connections. If finance policy is to be a potent force for school reform, finance systems will need to include mechanisms that reach the school site.

There is more than one reason why establishing such a link might make sense. Arguably, creating relationships between the state and schools gives the state a greater and more direct role in promoting innovation and change. Moreover, because schools are the unit of production (i.e., the point at which services are provided to children), a state-school relationship offers the state a much more direct link to student outcomes.

Consider, for example, the idea of providing schools with a budget or grant specifically for innovation and school improvement that does not pass through the central office. This is essentially what a number of states have initiated on a pilot basis. Usually, there is great flexibility in the allocation and use of these resources, and schools may even be encouraged to apply for waivers as they redesign their programs and strategies. Other states have established a series of rewards and sanctions triggered by performance and which go directly to schools and/or individuals in schools.

However, while such linkages can and do exist today, they are typically marginal efforts, initiated on a pilot basis, and they reach only a fraction of the schools and affect a very small percentage of the student population. Designing mechanisms that link funding to school-based change efforts could extend such efforts to many more districts and students.

Second, there are few direct relationships between the distribution of state aid and the research on effective practice in schools and school districts. Current finance policy in most states is almost entirely unrelated to policy concerned with school

A larger leap would be from tracking inputs to monitoring outcomes, leaving questions of resource deployment entirely to local officials.

effectiveness and reform. Given that state finance systems often govern the use of the vast majority of resources for the schools, building connections between the distribution of funds and information on what works in districts and schools would seem to make sense. Not only are the points associated with school restructuring — new approaches to teaching and learning, enhancing the institutional competence of schools (e.g., new approaches to teacher training and development keyed to new certification and licensure requirements), new forms of governance and management and the introduction of incentives tied to preferred outcomes — targeted principally at schools, but they are also related in some way to an emerging knowledge base on good practice.

Bringing finance policy in line with policy on school effectiveness and reform could happen in a number of ways. One approach might be creating categories of funding tied directly to new programmatic policy objectives. For instance, if an emerging goal is collaboration among schools and other agencies serving children and youth, as well as among schools, parents and the business community, it might make sense to create a fund or grant program that focuses specifically on this outcome. An alternative might grant tax authority at the local level for specific kinds of services and activities such as research-based school improvement efforts, newly coordinated services or school consolidation/reorganization initiatives. Isolated examples of these practices can also be found around the country. The norm, however, is that categories of funds and funding streams are unrelated to current priorities for programmatic reform.

New notions of accountability and control. If the traditional funding streams are potentially inconsistent with school restructuring, what about the forms of accountability and control that have historically been associated with school finance policy? It stands to reason that some, if not all of the ways one thinks about accountability in school finance, will need to change. For instance, if a new policy goal is to foster collaboration and cooperation in programming, what happens to the tradition of "supplement not supplant?"

The appropriateness of other "strings" might also be challenged in the name of reform. States frequently spend time coming up with definitions of pupils — learning disabled, emotionally disturbed, at risk — guessing about costs of serving these populations and then carefully tracking the dollars spent on each type of student. The district response usually is to become expert at program cost accounting and to organize services to meet these monitoring demands, regardless of whether more productive or efficient forms of organization and service delivery are possible.

An alternative to this might be to allocate and monitor funds in relation to the services provided, rather than to the characteristics of students served. This gets the monitoring and tracking focus off inputs and onto context and process (the setting in which services are provided and the specific instructional and related activities required).

A larger leap would be from tracking inputs to monitoring outcomes, leaving questions of resource deployment entirely to local officials. Current finance policy, whether concerned with regular or exceptional students, either assumes

certain student outcome effects or simply ignores them. Compliance and successful program implementation has meant that students were served, not that they achieved at higher levels.

The norms and standards of accountability with respect to the use of funds should not remain separate from the strategies for making schools more productive. The accountability systems associated with state finance systems may need to be designed and/or modified in ways that will help focus on the innovation and change efforts currently under way in the schools.

Conclusion

The factors stimulating a resurgence in school finance include a combination of traditional and new issues. There is a sense that the school finance reforms of the last 20 years have not produced their intended outcomes related to equity. Longstanding issues regarding the appropriate measurement of costs and fiscal capacity and the inclusion of mechanisms addressing the special needs and characteristics of school districts are apparently still issues. It is realistic to expect school finance activity to increase over the next few years as questions about the fairness and adequacy of state finance systems increase and as the courts focus their attention on these issues.

However, the policy debate in school finance in the 1990s is likely to extend beyond the traditional issues of equity and adequacy. The debate will be complicated by questions of school productivity or efficiency. The agenda around "restructuring" the schools is in many respects an effort to address the perception, if not the fact, that schools are producing less-than-desired results. This has the potential of creating new tensions among competing state goals. How policy makers address the need to make qualitative improvements in the schools while making progress on equity may be the challenge of the 1990s. One certainty is that state school finance systems will be in the center of this debate.

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APPENDIX ONE

SCHOOL FINANCE LITIGATION

State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
AZ	**1973**, St. Supreme Ct. 1972, County Superior Ct. 1971, filed	**Shofstal v. Hollins** plaintiffs * students & parents from Maricopa County	**Upheld** * education fundamental right * "rational & reasonable basis" test sufficient to uphold system	* trial court granted summary judgment that the finance system discriminated against taxpayers in Maricopa County under equal protection clause; judgment to take effect at close of 1974 legislative session; effective July 1, 1974, legislature repealed entire school financing statutory framework * trial court denied students' claim of denial of right to an education * Supreme Court reversed trial court's order to revise finance system and upheld system; remanded case for further proceedings * added pupil weighting element to existing foundation program (1974, 1980 reforms)
AR	**1983**, St. Supreme Ct. 1981, trial ct. 1977, filed	**Alma School Dist. No. 3 v. Dupree** plaintiffs * 11 school districts, students from one of the districts & members of the local school boards	**Overturned** * violated equal protection & education clauses * education fundamental right * unequal education opportunity among districts * no rational relationship between finance system & educational needs of districts	* plaintiffs claimed inequities in distribution of funds & educational opportunities * plaintiffs complained about state not providing aid for capital construction, strict limit on bonded indebtedness, method of funding vocational education * court findings: (1) higher priority to be placed on equity than local control, (2) disparities in staff, class size, curriculum, remedial services, facilities, material, equipment * after circuit court invalidated finance system, legislature established Governor's Commission on Public School Finance to develop proposals for more valid finance system to be implemented in '83 session * commission recommended: incorporate categorical programs into general aid system through pupil weights; local fiscal capacity to include measure of income & property wealth * legislature passed statewide education reform package in 1983; part of package combined existing foundation program with a pupil weighting system

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State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
CA	**1971**, St. Supreme Ct. 1968, filed	**Serrano v. Priest** plaintiffs * students & parents from LA County school districts	**Overturned** * violated equal protection clause * education fundamental right * property wealth a suspect classification * applied fiscal neutrality standard	* landmark case; court decision based partly on "fiscal neutrality" standard; provided courts with "judicially manageable" standard to determine constitutionality of school finance systems * first state public school finance system declared unconstitutional; first major school finance case filed in state rather than federal court * 1972, legislature increased state aid as part of new finance formula; moved to a foundation program
CA	**1976**, St. Supreme Ct.	**Serrano v. Priest II**	**Overturned** * affirmed 1974 trial court ruling that finance system violated equal protection clause	* 1974, trial court declared current financing system unconstitutional despite increase in state aid enacted in 1972; quality of education remained function of local school district wealth * legislature unable to implement Assembly Bill 65 (1977) - a new finance formula measure, due to Proposition 13 (1978) which limited property tax rates to 1% of full cash value of real taxable property & reduced available revenue
CA	**1986**, Appellate Ct.	**Serrano v. Priest III**	**Upheld**	* state had complied with Serrano II mandate to improve equity - 95% of school districts fell within maximum expenditure disparity of $200 per pupil in 1982-83
CO	**1982**, St. Supreme Ct. 1979, district ct. 1977, filed	**Lujan v. Colorado State Board of Education** plaintiffs * 68 students from 16 low-wealth districts	**Upheld** * did not violate equal protection or education clauses * education not fundamental right	* suit attacked use of flat grants & Authorized Revenue Base (ARB) * supreme court reversed district court ruling that finance system was unconstitutional * local control viewed as rational basis for existing disparities & as a legislative purpose of education financing statutes * education clause did not mandate equal expenditure per pupil * legislature enacted HB1341, Public School Finance Act of 1988; moved from a guaranteed yield to a foundation program with district "setting categories"; a pending lawsuit was withdrawn * legislature established Colorado Commission on School Finance to review, analyze and evaluate HB1341

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CT	**1977**, St. Supreme Ct. 1974, St. Superior Ct. 1973, filed	**Horton v. Meskill** plaintiffs * students in Canton, CT	**Overturned** * violated equal protection and education clauses * education fundamental right	* court declared it was not appropriate to rely on local property tax to finance education without regard to local ability to support adequate education; also caused tax disparities * 1978 - trial court set May 1, 1979, deadline for enactment of constitutional plan for financing schools * Public Act 79-128 enacted April 1979, included guaranteed tax base formula & minimum expenditure requirement; replaced flat grant program
CT	1982	**Horton v. Meskill II**		* municipalities were denied intervention in remedial proceedings
CT	1985, St. Supreme Ct.	**Horton v. Meskill III**	**Upheld**	* plaintiffs challenged Public Act 79-128 (1979) on basis of long phase-in period, "hold-harmless" clause for wealthy towns and continued disparities in local expenditure * Supreme court remanded to superior court in 1986 with guidelines for determining constitutionality of subsequent amendments * neither side continued to pursue case * 1989, legislature passed education enhancement act - increased education spending and created new finance formula (SB539) which replaced guaranteed tax base with foundation formula

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State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
GA	**1981**, St. Supreme Ct. 1981, St. Superior Ct. 1974, filed	**McDaniel v. Thomas** plaintiffs * members of 3 local school boards and students	**Upheld** * did not violate equal protection or education clauses * education not fundamental right	* Supreme court reversed trial court decision which held finance system unconstitutional - violated fiscal neutrality standard * equal protection language not present in education section of state constitution, therefore, such analysis not applicable * preservation of local control viewed as rational basis supporting finance system * although system was upheld, court concluded steps should be taken to equalize educational opportunities & solutions must come from lawmakers; legislature's role to interpret mandate of "adequate" education as stated in education clause * the Quality Basic Education (QBE) law of 1985, a state education reform act, included funding equalization measures: dramatically increased state and local contribution to education
ID	**1975**, St. Supreme Ct. 1973, lower ct. 1972, filed	**Thompson v. Engleking** plaintiffs * students & parents from Pocatello School Dist. No. 25	**Upheld** * did not violate equal protection or education clauses * education not fundamental right	* reversed 1973 trial court decision that finance system violated state constitution education clause

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KY	**1989**, St. Supreme Ct. 1988, circuit ct. 1985, filed	**The Council for Better Schools v. Rose** plaintiffs * 66 low-wealth & rural districts	**Overturned** * entire state system of school finance & governance violates state constitution's education clause	* initiated as school finance case in which plaintiffs claimed wide expenditure disparities existed between districts * landmark decision declaring entire state education system unconstitutional * school system underfunded & inadequate; cited: poor national & regional rankings in pupil expenditure & achievement, low teacher salaries, high dropout rates * minimum foundation & power equalization program allowed wide variations in financial resources, resulting in unequal educational opportunities * legislature permitted local districts to levy optional taxes, exacerbating inequities; great local waste & mismanagement existed * struck down: school finance system; laws creating school districts, school boards, state education department; laws & regulations concerning teacher certification & school construction * established task force composed of legislatures & representatives from governor's office to comply with court order that legislature devise plan to provide adequate funding for a more equitable school system by mid-July 1990 * three committees formed - curriculum, finance, governance - headed by outside consultants * education and tax reform bill (HB940) passed in March 1990 & signed by governor in April * HB940 included: performance-based system of rewards & sanctions for schools & teachers, reorganization of state department of education, limit on amount districts could spend, revision of foundation & power equalization program, raised minimum mill rate

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State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
MD	**1983**, St. Ct. of Appeals 1981, circuit ct. 1979, filed	**Somerset County Board of Education v. Hornbeck** plaintiffs * members of local school boards, superintendents, mayor of Baltimore, students & parents	**Upheld** * did not violate equal protection or education clauses	* state court rejected claims of municipal and educational overburden; education clause did not mandate equal per pupil funding or expenditure * state court reversed trial court's decision which held the finance system violated education clause * trial court recognized: poor districts remained underfunded while no spending limit was placed on other districts; claims of municipal & educational overburden; variation of property wealth created spending disparities; low percent of state contribution to education, most of which was unequalized
MT	**1989**, St. Supreme Ct. 1988, District Ct. 1985, filed	**Helena School Dist. No. 1, et al. v. State of Montana, et al.** plaintiffs * 65 school districts	**Overturned** * violated education clause	* court held: foundation program relies too heavily on property tax levies & denies equal educational opportunity to students in poor districts * in compliance with court order, legislature passed bill (HB28) during July 1989 special session which revised school finance formula * HB28: appropriated $375 million for K-12 in FY91; increased state support by adopting foundation schedules $67.2 million higher than FY89; instituted a local levy cap (up to 35% of foundation amount) * HB28 financed by mandatory 95 mill levy (previously 45 mills), 5% surtax on individual and corporate income taxes and reallocation of other tax revenues * plaintiffs filed brief: (1) contended that ruling extends beyond general fund to capital outlay & transportation which HB28 does not address; (2) argued HB28 is not permanent, stable funding source, does not address teacher retirement inequities and won't adequately reform per-student spending inequities; (3) requested court to extend declaration of constitutionality of enacted provisions until July 1, 1991, to allow for HB28 to go into effect, collect more accurate data and allow legislature more time to address issues
MI	**1984**, St. Ct. of Appeals 1982, filed	**East Jackson Public Schools v. State of Michigan** plaintiffs * 20 school districts & students	**Upheld** * did not violate equal protection or education clauses * education not fundamental right	* plaintiffs alleged reliance on state equalized valuation (SEV) of taxable property allows for disparities; state does not equalize for expenditure differences which result in unequal education programs * court held that to provide free public education is not synonymous with providing equal financial support

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State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
NJ	**1973**, St. Supreme Ct. 1972, County Superior Ct. 1970, filed	**Robinson v. Cahill** plaintiffs * mayors, members of city councils & school boards of 5 cities, a student and a taxpayer	**Overturned** * violated equal protection and education clauses	* plaintiffs asked for: finance system to be ruled unconstitutional and revised; district boundaries to be redrawn; and for property tax system to be ruled unconstitutional to extent it was used to fund public schools * plaintiffs' claims against finance system: violated education clause, unequal tax burden on low property value districts, violated fiscal neutrality standard, racial discrimination * first case to rule finance system violated education clause of state constitution; did not provide "thorough & efficient" education system * in compliance with court order to establish reforms, legislature enacted Public School Education Act of 1975 (S.1516) * funds for public schools were enjoined and schools were closed for 2 weeks after legislature failed to assure full funding for new act by July 1, 1976; legislature enacted income tax to fund act & injunction was lifted

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State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
NJ	**1990**, St. Supreme Ct. 1981, filed	**Abbott v. Burke** plaintiffs * students in 4 urban districts	**Overturned** * violated education clause * system unconstitutional as applied to poorer urban districts	* plaintiffs contended Public School Finance Act of 1975 was not properly funded and allowed financial disparities to remain excessive; state argued local school districts guilty of educational mismanagement * superior court dismissed suit in 1983; appellate court ruled in favor of the plaintiffs in 1984; state supreme court reversed appellate court decision in 1985 & remanded to administrative law judge * state supreme court ruled that administrative remedies must be exhausted before court could rule on merits of suit * August 1988, administrative law judge ruled school finance system unconstitutional - violated education clause; decision forwarded to commissioner of education who upheld state's position * Supreme court ruled finance system unconstitutional as applied to poorer urban districts; 28 districts identified * court also held: minimum aid provisions unconstitutional; act must be amended to assure funding in poor urban districts at level of property-rich suburban districts - funding cannot depend on ability of district to tax and must be guaranteed and mandated by state; funding must provide for special educational needs of poor urban districts * court addressed areas of categorical, transportation, pension and capital outlay aid * court recognized deficiencies in curricula; need for better services and programs, including early childhood * dismissed deficiencies in education being primarily related to mismanagement rather than expenditure per-pupil differences * July 1990, legislature enacted Quality Education Act of 1990, based on governor's recommendations * Act allocated $1 billion in additional state aid (funded through income and sales tax increase); phased-out minimum aid to wealthy districts; wealthy districts to absorb their costs for teacher pensions; set high foundation level ($6,835 for elem. & additional amounts for sec. for 1891-92); established "special needs" districts; accountability measures

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NY	**1982**, St. Ct. of Appeals 1981, Appellate Division of St. Supreme Ct. 1978, County Supreme Ct. 1974, filed	**Board of Education, Levittown v. Nyquist** plaintiffs * boards of education & students from 27 districts & 4 large cities	**Upheld** * did not violate equal protection or education clauses * education not fundamental right or interest	* plaintiffs from large urban districts claimed municipal and educational overburden * state court of appeals reversed two lower court decisions * court recognized existence of significant disparities; "judicially imprudent" to rule unconstitutional, partly due to lack of proper remedy * preservation of local control viewed as rational basis supporting finance system * no requirement for education to be equal in every district, must only provide minimal, acceptable facilities & services
OH	**1979**, St. Supreme Ct. 1977, county ct. 1976, filed	**Board of Education of the City School District of Cincinnati v. Walter** plaintiffs * Cincinnati board of education, district superintendent, parents, students	**Upheld** * education not fundamental right * preservation of local control rational basis supporting finance system	* plaintiffs alleged: burden on districts to raise excessive portion of education funds to meet requirements - dependent on voter approval of tax levies, rather than on cost to provide thorough and efficient education * plaintiffs claimed municipal & educational overburden * plaintiffs challenged fiscal penalty - reduced state aid for district's inability to meet mandated educational standards * supreme court reversed county court decision * court reluctant to judge whether system "thorough and efficient" - function of General Assembly * education opportunity not absolutely denied
OK	**1987**, St. Supreme Ct. 1980, filed	**Fair School Finance Council of Oklahoma v. Oklahoma** plaintiffs * 38 school districts, students, taxpayers	**Upheld**	* constitutional limit on property tax level and other restrictions complicated property-poor district's ability to raise adequate amount to support educational services; plaintiffs claimed great financial disparities among districts existed * flat grant program provided same amount of aid to all districts & foundation program failed to close gaps * 1981, legislature revised finance system - pupil-weighting scheme using foundation & guaranteed tax base; 1982, added $150 million to finance system

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State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
OR	**1976**, St. Supreme Ct. 1975, circuit ct. 1972, filed	**Olsen v. Oregon** plaintiffs * class action suit on behalf of all public school children in state except in high-wealth districts; taxpayers	**Upheld** * did not violate education clause * preservation of local control served as rational basis supporting finance system	* plaintiffs claimed flat grant program had disequalizing effect & finance system violated fiscal neutrality standard * court ruled that the interest impinged upon - educational opportunity - was outweighed by objective to maintain local control
TX	**1973**, US Supreme Ct. 1971, district ct. 1968, filed	**San Antonio Indep. School Dist. v. Rodriguez** plaintiffs * parents from Edgewood School Dist.; class action suit on behalf of poor & minority students	**Upheld** * education not fundamental right of US Constitution & did not require strict scrutiny under 14th Amendment (equal protection clause)	* district court ruled finance system unconstitutional under equal protection clause of 14th Amendment - significant disparities in school expenditure existed * US Supreme Court declared system did not deny opportunity to obtain basic minimal skills * rejected "poor students" or "poor school districts" as suspect class * cited importance of local control * historic case which eliminated federal courts as receptive forum to school finance cases since education not fundamental right under US Constitution and cannot be held to strict scrutiny * provided guideline for state courts: if importance of education mentioned in state constitution, such language allows for, but does not necessitate, fundamental interest status of education

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State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
TX	**1989**, St. Supreme Ct. 1988, Ct. of Appeals 1987, district court 1984, filed	**Edgewood Indep. School Dist. v. Kirby** plaintiffs * 67 districts & 14 families	**Overturned** * violated education clause	* history: (1) May 1989, legislature appropriated additional $450 million to equalize districts over 2-year period - court recognized low impact on system that spends $12 billion annually; (2) 1977-84, legislature distributed $1.1 billion in equalization aid; (3) 1984, passed education reform act HB72 - revised school funding system - created two-tier system which funded based on pupil units, increased equalization aid & general funding to poor districts; system remained underfunded * basis of suit: inequity of and reliance on local property taxation * 1987, trial court held in favor of plaintiffs; 1988, Third Court of Appeals reversed decision; 1989, State Supreme Court unanimously reversed court of appeals & declared school finance system unconstitutional * supreme court affirmed use of "fiscal neutrality" standard, but qualified: school districts must have "substantially equal access" to similar revenues per pupil at similar levels of tax effort * state finance program - Foundation School Program, does not cover cost to meet state-mandated minimum requirements, no allotments for school facilities or debt service * court held, "... state's school financing system is neither financially efficient nor suitable in the sense of providing for a 'general diffusion of knowledge' statewide" - violated education clause * state comptroller ordered to stop payments to public schools after court imposed deadline of May 1, 1990, for legislature to devise plan to reduce wide funding disparities between districts & achieve efficient system - or at least to generate equalization money for 1990-91' school year and then concentrate on permanent solution next legislative session * legislature & governor failed to reach consensus by May 1 deadline; court appointed "special master" to develop plan in case consensus could not be met * to work within existing resources, "special master" proposed plan to shift state aid from wealthy to poor districts * during fourth special legislative session, SB1 was

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State	Procedural History	Case/Plaintiffs	Ruling	History/Context/Developments
				* SB1 included: (1) maintains two-tier foundation & guaranteed yield program, (2) changed pupil-weighting system, (3) raised guaranteed yield, (4) changed pupil count measurement, (5) $4 billion in new funds over 5-year period, (6) allows "equity standard" to change based on accountable-cost study, (7) addressed issues relating to governance, school-based management, regulation waivers, early childhood
WA	**1974**, St. Supreme Ct. 1972, filed	**Northshore School Dist. v. Kinnear** plaintiffs * school districts, students, parents, taxpayers	**Upheld** * did not violate equal protection or education clauses	* plaintiffs alleged violation of fiscal neutrality standard and disparities in expenditure, education quality & tax rate * "uniform & general" system only requires certain minimum educational opportunity * dissenting judge found state aid to have nonequalizing effects & to violate education clause; laid ground for subsequent lawsuit
WA	**1981**, County Superior Ct. 1978, St. Supreme Ct. 1977, Superior Ct. 1977, filed	**Seattle School Dist. No. 1 of King County v. Washington** plaintiffs * 24 school districts, education associations & advocacy groups, and others	**Overturned** * violated education clause	* plaintiffs contended that 40% of Seattle's education budget dependent on passage of annual referendum; without passage, cannot meet state requirements * 1978, supreme court held trial court's decision declaring school finance system unconstitutional - violated education clause * supreme court stated that legislature had duty to define "basic education" & provide for funding through regular & dependable taxes * 1981, plaintiffs filed suit in state supreme court claiming state failed to define & fund basic education * case transferred back to county superior court which ruled "basic education" must include handicapped, bilingual & remedial programs; revenue shortfalls not legitimate excuse for failure to provide adequate funding * state has since adopted finance plan relying heavily on state support

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WI	**1976**, St. Supreme Ct.	**Buse v. Smith** plaintiffs * "negative aid" school districts, taxpayers, school board members, parents, residents	**Overturned** * "negative aid" provision violated uniformity clause of a state constitution tax article	* plaintiffs challenged "negative aid" or "recapture" provision of 1973 School Finance Act * supreme court struck down negative aid provision; violated principle of state constitution article in that taxes levied in one district could not be used for direct benefit of other school districts or for sole benefit of the state
WI	**1989**, St. Supreme Ct.	**Kukor v. Grover** plaintiffs	**Upheld**	* plaintiffs contended finance system did not take into account special needs of districts that enroll high percentage of "at-risk" students * court held that resolving inequities among districts is responsibility of legislature, not courts

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WV	**1982**, circuit court **1979**, St. Supreme Ct. 1977, circuit court 1975, filed	**Pauley v. Bailey** plaintiffs * parents & students of Lincoln County	**Overturned** * violated equal protection and education clauses * education fundamental right * wealth as suspect classification	* 1979, state supreme court reversed trial court's dismissal of plaintiffs' complaint & remanded case to circuit court * circuit court of Kanawha County found finance system unconstitutional: - did not provide equitable & adequate funding for thorough and efficient system - costs for programs such as special education, remedial education, early childhood must be reflected in funding formula - inadequacies & inefficiencies (as defined by educational inputs) resulted from finance system & related to varied educational resources & expenditures among counties - reliance on locally funded excess levies to provide "thorough & efficient" system was unconstitutional - state failed to provide adequate funding for school construction - taxation & assessment of property is not equal or uniform * addressed not only financial & educational equity, but quality & substance of education * court ordered executive & legislative branches to develop master plan to create equitable, high-quality education system in regard to staff, facilities, courses & to correct offering disparities by 1983 * Master Plan for Education which addressed roles of state & local education agencies, educational facilities and changes in finance system approved by trial court in 1983
WY	**1980**, St. Supreme Ct. 1979, trial court 1978, filed	**Washakie County School Dist. No. 1 v. Herschler** plaintiffs * 3 districts & school board members, taxpayers, parents, students	**Overturned** * violated equal protection and education clauses * education fundamental right	* court supported claim that disparity in financial resources is related to quality of education * court declared, "no trial is necessary in this case because, as a matter of law, the statutory structure is inherently defective" * court ordered legislature to adopt constitutional system of finance by July 1, 1983 * revised school funding system in 1983, including a recapture provision

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APPENDIX TWO

STATE STUDIES OF SCHOOL FINANCE

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APPENDIX THREE
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GLOSSARY OF SCHOOL FINANCE TERMS

Assessed Valuation: The value of a taxable property as determined by a government agency or tax assessor. Taxes are paid on the basis of a property's assessed valuation. The assessed valuation of property in most states and localities is usually less than the market value of the property.

Assessment Ratio: The assessment ratio is the ratio of actual assessed valuation to market valuation.

Categorical Aid: State or federal aid that is designated for a specific use. Examples are transportation aid, special education aid, aid for vocational education and aid for capital construction.

District Power Equalization: District power equalization (DPE) refers to a state equalization aid program that "equalizes" the ability of each school district to raise dollars for education. In a pure DPE program, the state guarantees to both property-poor and property-rich school districts the same dollar yield for the same property tax rate. In essence, equal tax rates produce equal per-pupil expenditures. DPE programs are given different names in different states, including Guaranteed Tax Base Programs (GTB), Guaranteed Yield Programs (GTY) and Percentage Equalization Programs (PE). Each focuses on local ability to generate revenue for schools.

Equalization: The process of compensating for differences in order to make equal. Several related concepts are useful. **Capacity equalization** is the process of compensating for differences in school districts' ability to support education in order to achieve student equity and taxpayer equity. **Service and programmatic equalization** is the process of compensating for differences in the level of services or programs in a school or school district in order to achieve student equity.

Fiscal Capacity: The total economic resources available to a government for tax purposes. In school finance, fiscal capacity is generally defined as property valuation per pupil, but several states include income or other measures of wealth with property valuation as a measure of fiscal capacity.

Foundation Program: A foundation program is a state equalization aid program that typically guarantees a certain foundation level of expenditure for each student, together with a minimum tax rate that each school district must levy for education purposes. The difference between what a local school district raises at the minimum tax rate and the foundation expenditure is made up in state aid.

Foundation or Guarantee Level: That level of per-pupil expenditures guaranteed to all school districts in a state through a combination of state aid and locally raised revenue.

General Aid: State or federal aid that can be used by a school district for any purpose.

Guaranteed Tax Base (GTB): See District Power Equalization.

Guaranteed Yield Program (GTY): See District Power Equalization.

Impact Aid: A program that provides assistance to school districts that serve significant numbers of children whose parents either work for the federal government or reside on property owned by the federal government.

Local Leeway: In state aid programs, the right of a participating district to tax itself at a rate above the mandated local tax effort or spend above a specified level of expenditure.

Percentage Equalization Program: See District Power Equalization.

Property Tax Circuit Breaker Program: A tax relief program, usually financed by the state, that focuses property tax relief on particular households presumed to be overburdened by property taxes. It is intended to reduce the presumed regressivity of the property tax. A typical circuit breaker program attempts to limit the property tax burden to a percent of household income and applies only to residential property taxes (a few states apply such relief to agricultural property). The percent usually rises as income rises in an attempt to make the overall burden progressive. Most states enacted circuit breaker programs initially just for senior citizens, but some have extended relief to all low-income households, regardless of age.

Pupil Count: The method of counting students served by the public schools. Several methods are frequently used. **Average Daily Attendance** is the actual presence of enrolled students counted at two or more times during the school year and averaged over the number of counts. **Average Daily Membership** is the number of students enrolled, counted at two or more times during the school year and averaged over the number of counts. **Full-Time Equivalent (FTE)** pupils is a count reflecting the amount of time a student spends in particular instructional programs or services. For instance, a student might spend 50% of his/her time in a program for exceptional students and the remaining 50% in a regular instructional program. The FTE count would be 1.00.

Pupil-Weighted Systems: A state aid system in which pupils are given different weights based on the estimated or assumed costs of their education program. Aid is allocated on the basis of the total number of weighted students. Usually, the cost of the education program for grades 4-6 is consider the standard program and weighted 1.0. States using this approach might decide to invest more heavily in the early grades, in effect "weighting" these students more heavily (typically around 1.30). High school students might also receive more weight (typically 1.25). The major education program areas where weights are frequently used are special education and vocational education. The weights depend on the number of categories of students or services defined.

Recapture: A feature in state aid to education formulas where local districts that raise an amount per pupil in excess of the state guaranteed expenditure per pupil would have to pay back the excess to the state for redistribution to poorer schools (i.e. those with less valuation per pupil).

Required Local Tax Rate: A term indicating the mandated property tax rate required for participation in the state aid system. The required local tax rate is usually associated with a foundation program and is often expressed in terms of **mills**. A millage rate is the amount of property tax dollars to be paid for each $1,000 of assessed valuation.